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REAL ESTATE OUTLOOK

Vol. 1, No. 1 January 1988

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The third quarter annual growth rate of real GNP was revised upward to 4.1 percent on the basis of stronger business fixed investment spending and faster net export growth. This report confirmed the momentum in the U.S. economy prior to the stock market crash.
- Post-crash economic indicators suggest the economy may be shrugging off the effects of the stock plunge sooner than anticipated. Among the positive indicators: substantial employment gains, growing U.S. exports and a higher rate of industrial production.
- Real GNP growth should rise slowly in the first half of 1988 reflecting the adverse effects of the stock plunge. Growth in net exports should propel the economy out of this sluggish period and into a stronger second half. Overall, real GNP growth in 1988 could slow to a 2.2 percent rate compared to the 2.8 percent rate of 1987.
- Inflation is expected to average about 4.4 percent through 1988, as the dollar declines further to shrink the trade deficit, but ultimately raising consumer prices at home.
- Mortgage rates are expected to trend down modestly through 1988, but staying above 10 percent. The average rate on a 30 year FRM is expected to be about 10.6 percent in 1988.
- Sales of existing single-family homes will slow to an average annual rate of 3.2 million units in the first half of 1988, and 3.3 million units in the latter half. For all of 1988, existing single-family home sales will average 3.24 million units, an 8 percent decline from the 1987 estimated rate of 3.52 million units.
- Housing starts should also decline in 1988, to about 1.52 million units, down almost 8 percent from the 1987 estimated annual rate of 1.65 million units. Single-family starts are expected to fall 6 percent to 1.1 million units in 1988, from 1.17 million units in 1987.

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THE RETURN OF COMET HALLEY: Economic Commentary

by
John A. Tuccillo
Chief Economist and
Senior Vice President
Real Estate Finance

At this time three years ago, comet-mania was just sinking into the American consciousness. We were eagerly awaiting the reappearance of comet Halley after its 75-year tour of the outer reaches of the universe. Our material nature led to the production of T-shirts and other memorabilia; our spiritual sides focused on the dire consequences that would attend such an infrequent celestial event. But both sides agreed that it would be a big, meaningful deal. You know what? It wasn't. The great comet appeared as a dim light just above the horizon and had virtually no effect on the course of the world.

Well, welcome to those thrilling days of yesteryear. We have produced another comet Halley in the form of the stock market crash. We expected that the economy would collapse, that the world we knew would be shattered. In reality, the events of mid-October will, like comet Halley, affect only those who get caught up in the mania. We expected a bang, but we got a whimper.

Since the crash, the economic news has been good to mixed. Consumer confidence appears to be down since the crash (but has not been shattered); housing starts and new home sales are down. But, durable goods orders rose in October, and employment increased in both October and November.

I think there are two points to be made here. First, it is too early to tell whether the stock market collapse will significantly reduce economic growth. All our third quarter numbers point to significant underlying strength in the economy at large. Right now, that strength appears to be enough to overcome the crushing blow to confidence administered by Wall Street. As we move into the first quarter of 1988, the outcome of this struggle will become apparent.

The second point deals with the comparisons between 1987 and 1929. Surely, we have in both periods a booming economy with several depressed sectors, a hotly speculative stock market and significant foreign trade problems. But there is one major difference. Clearly, the MVP of the Crash of '87 has to be the Fed. Unlike 1929, when the monetary authorities snatched defeat from the jaws of victory by sucking liquidity out of an economy in sore need of it, the Fed in 1987 opened wide the lending window and provided the funds that kept a crash from becoming a depression. And just as important, after the initial shocks subsided, the Fed dried up this extra liquidity to prevent the development of excess inflation. In all, a textbook case of policy execution.

But, given that this is a time of uncertainty, where should one look to divine the future? Perhaps focusing in on four major numbers will be helpful.

1. The Dow-Jones Average. The D-J has never been a measure of real economic activity, but it serves as a psychological indicator that may affect economic behavior. Currently, the Dow is about where it was a year ago (and about 650 points above where it was when comet Halley attempted to reappear). If it consistently moves within a 50-100 point range of its current level, then the strength of the economy will prevail. The October episode will have served to wring excess speculation out of the market with little ultimate impact.

2. The Dollar v. Interest Rates. The falling dollar will stimulate production but will lead to higher inflation; falling interest rates will stimulate production and may lead to more inflation. Clearly, the economy will be strong if both the dollar and rates drift downward. Should the dollar go into freefall, we could easily lapse into a 70's-style stagflation. At its present pace, the fall in the dollar will lead to higher growth in 1988.

3. Consumer Confidence. Post-October 19 polls show a significant drop in consumer confidence, but far short of disaster. In addition, Christmas sales appear to be down only slightly. Two consecutive months of drops in consumer expenditure exceeding 0.5 percent, with no improvement in confidence indices, will signal that the stock market collapse was an early indicator of recession.

4. Leading Indicators. The Index of Leading Indicators has been a much maligned economic statistic. Currently, the index is falling, largely owing to the inclusion of the Dow-Jones as one of its components. Remove the Dow and the index is rising. Should this trend continue, then the economy will remain strong; a fall (absent the D-J) of three consecutive months will precede a recession.

You can, and should, follow each of these numbers in the press. We believe, as you can see in our forecast, that the stock market crash will dent the economic expansion, but not stop it. In fact, we look for a resurgence of growth in the second half. In effect, we see the events of October as comet Halley, promising much, inspiring awe, but ultimately being less than the momentous event of the decade.

Outlook for the Economy and Real Estate

The first readings on the economy's overall health after the stock market crash are beginning to trickle in and they suggest the pre-crash momentum of the economy may offset some of the anticipated immediate negative effects of the stock market crash. The upshot is that if economic growth continues at the pace set by the new indicators, then the U.S. economy will only experiece a modest economic slowdown in the first half of 1988, thus averting a recession.

The preliminary real GNP annual growth rate for the third quarter had been reported at 3.8 percent but was revised upward to 4.1 percent, confirming the economy's strength in the weeks preceding the market crash. Business fixed investment and net exports, both large contributors to third quarter growth, were found to be even stronger, forcing the upward revision. Alternatively, residential investment was weaker than originally reported, offsetting some of the upward revision.

Post-Crash Indicators

Post-crash indicators are still few and far between, but generally they describe an economy much stronger than was anticipated. The November employment report exactly reversed the October 0.1 percent rise in the unemployment rate, dropping it back down to 5.8 percent. In November, total employment, when measured on a household basis, rose 327 thousand to a nationwide employment total of 115.3 million. Throughout the first 10 months of 1987, monthly employment gains in the household survey had averaged 254 thousand. The establishment survey of payroll employment also recorded a substantial gain: up 247 thousand in November. These gains were widespread including both durable and nondurable goods industries, construction, and the service industries. Further, the factory workweek was calculated to be 41.2 hours long in November, an impressive mark when compared to historical standards. The importance of this positive employment report is twofold: it shows the economy is still creating thousands of jobs, and it implies that rising U.S. exports are fostering greater employment here.

Further proof of the positive impact export growth is having on U.S. industry can be found in the November industrial production index which rose 0.4 percent in that month, after strongly advancing 0.9 percent in the October report. Like the employment numbers, the output gains were spread across many industries. Production of home goods and business equipment showed considerable strength, while auto industry output posted a decline.

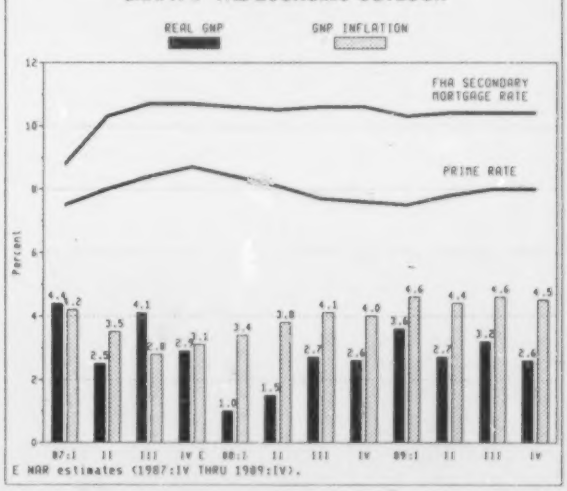
Producer price inflation remains very modest. Recent monthly reports have shown the index rising by small increments. In November, the producer price index for finished goods was unchanged, compared to a fall of 0.2 percent in October. Intermediate goods prices have been rising faster in recent months, with the November index for these goods rising 0.4 percent. Crude goods prices fell by 1.7 percent in November, the second monthly decline in three months, and a reversal of an eight month trend of increasing crude goods prices. According to this data, inflation does not seem to be creeping in through the domestic production process, despite rising industrial production and higher capacity utilization rates.

The preliminary report on November retail sales registered a 0.2 percent increase after two consecutive monthly declines. However, the September and October figures were revised down substantially, to -0.9 percent and -1.7 percent, respectively. Slower automobile sales in November were partly to blame for the meager 0.2 percent rise. Excluding sales at automotive stores, retail sales rose 0.4 percent in November.

The 1988 Outlook

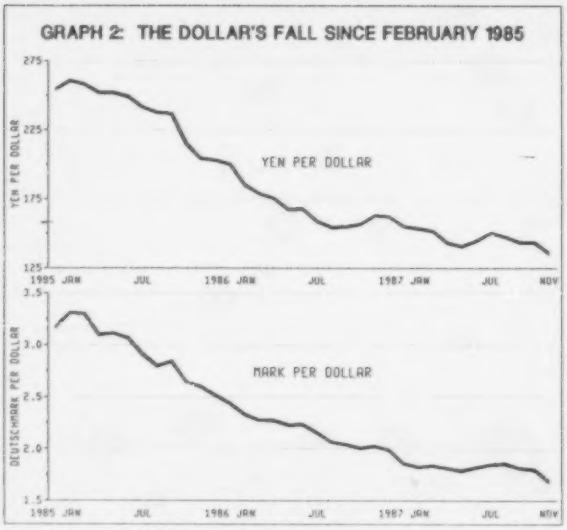
The economic outlook for 1988 framed by these indicators and the pre-crash economic momentum is depicted in Graph 1. While not falling into a recession, real GNP growth could rise by an average annual rate of 1.3 percent in the first half of 1988, a good deal slower than the 3.5 percent rate in the first half of 1986. The positive contribution of net exports during the first half of 1988 will keep the economy out of a recession, and lead it to a more robust second half average annual growth rate of 2.7 percent. Inflation (as measured by the GNP deflator) should increase moderately over the course of 1988, although this seems inconsistent with a slow growth forecast. In fact, inflation will continue to be driven by the declining value of the dollar rather than by an expanding economy. Fears of rising inflation will probably keep mortgage rates above the 10 percent mark through much of the year. On the short side, the prime rate could test the seven percent level again next year as the monetary authority helps avert a recession by using lower interest rates to stimulate the economy.

GRAPH 1: THE ECONOMIC OUTLOOK

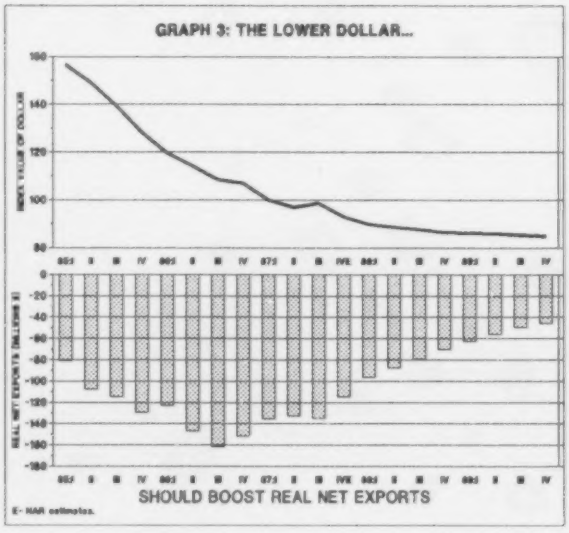


E NAR estimates (1987:IV THRU 1989:IV).

The success of virtually every economic forecast for 1988 lies in the assumptions regarding the value of the dollar. Graph 2 presents the fall in the dollar's value since February 1985 in both Japanese yen and W. German deutschmark terms. Early in 1987, the dollar's slide seemed to be nearing a point of stabilization, that was expected to be followed by further orderly and slow declines. These hopes were dashed in late March in a sort of chicken or the egg scenario where financial market participants debated if government reports of high inflation were already fully accounted for in the dollar's present value. The naysayers won out and the dollar tumbled, teaching a timely lesson about the new links between domestic mortgage rates and world asset prices, particularly mortgage-backed securities.

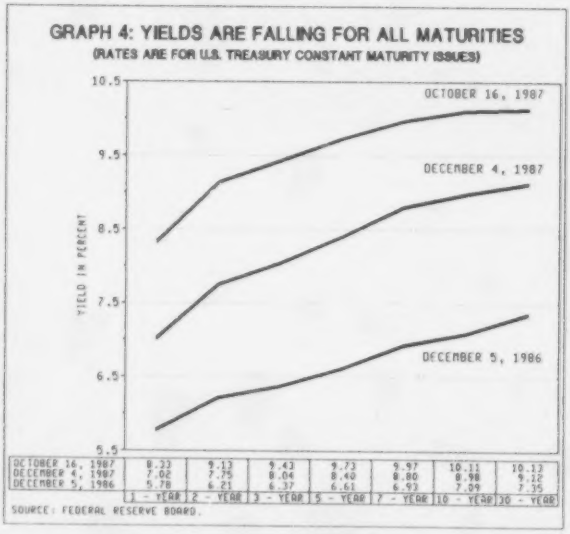


This forecast projects the dollar to decline by an additional 10 percent or more during 1988. Graph 3 not only shows this downward trend, but it also points out why the dollar must continue to fall. That is, not only will the dollar be forced down in value during 1988 by investors unwilling to hold dollar-denominated assets at the current exchange rate, but it must fall further to spur on improvement in the U.S. trade deficit. The effect of these improvements in U.S. trade performance is best measured by real (inflation-adjusted) net exports (exports minus imports). The graph shows that real net exports had been improving steadily since the third quarter of 1986, until they worsened slightly in the third quarter of 1987. This forecast projects further steady improvements in real net exports not only from the additional 10 percent depreciation of the dollar in 1988, but also from the lagged effect currency changes have on real trade flows.



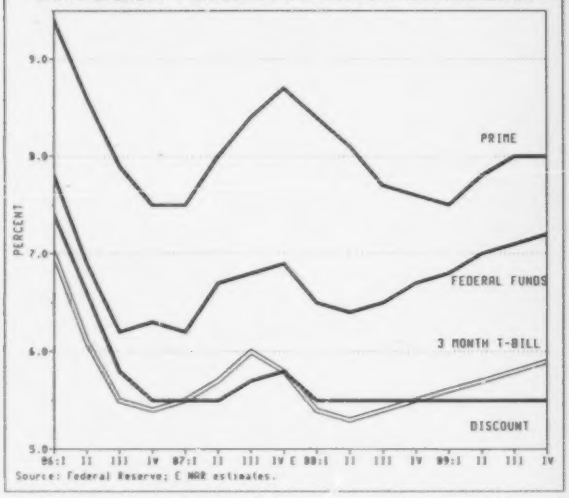
MONETARY POLICY AND INTEREST RATES

The Federal Reserve, as the monetary authority, has had the unenviable task of balancing the demand for liquidity immediately following the stock market plunge against the potential for inflation fears to sweep through the financial markets. With the addition of so much liquidity to the financial system, yields on instruments of virtually all maturities have fallen since the week ending October 16, 1987. On Graph 4, this is shown by a complete shift down in the yield curve from the top line to the middle line. The bottom line shows how the yield curve looked one year prior to the most recent data available. In 1988, this forecast projects that the yield curve will often reside between the December 1986 and December 1987 curves. Although the Fed appears to have mopped up the extra liquidity it pumped into the economy since the stock market plunge, it seems unlikely that it will risk a recession by keeping interest rates high.


GRAPH 4: YIELDS ARE FALLING FOR ALL MATURITIES
(RATES ARE FOR U.S. TREASURY CONSTANT MATURITY ISSUES)
OCTOBER 16, 1987
DECEMBER 4, 1987
DECEMBER 5, 1986
YIELD IN PERCENT
OCTOBER 16, 1987 | 8.22 | 9.13 | 9.43 | 9.73 | 9.97 | 10.11 | 10.13
DECEMBER 4, 1987 | 7.02 | 7.75 | 8.04 | 8.40 | 8.80 | 8.98 | 9.12
DECEMBER 5, 1986 | 5.78 | 6.21 | 6.37 | 6.61 | 6.93 | 7.09 | 7.35
1 - YEAR | 2 - YEAR | 3 - YEAR | 5 - YEAR | 7 - YEAR | 10 - YEAR | 20 - YEAR
SOURCE: FEDERAL RESERVE BOARD.

Graph 5 presents the current forecast for short-term interest rates. Following on the actions of the Fed to increase liquidity in the days following October 19, commercial banks lowered the prime rate in steps to 8.75 by the second week in November. From there, this forecast projects the prime rate to trend downward as the Fed acts to spark economic growth in the face of an economic downturn. As economic growth returns in the second half of 1988 and on into 1989, the prime rate and other short-term rates could begin to trend upwards. At present, the policy of the Fed appears to be to allow short-term rates to remain somewhat high through the end of 1987, before it has to act to force them down in the slow growth environment of the first half of 1988. As part of that expected policy move in the first half of 1988, the Fed might lower the discount rate to 5.75 percent and then 5.5 percent.

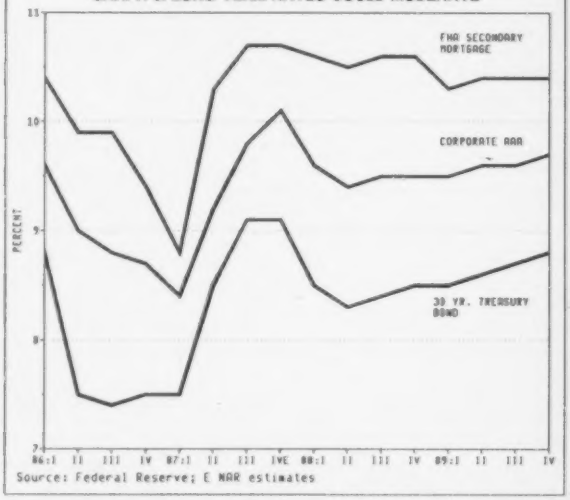
GRAPH 5: SHORT-TERM RATES SOFTEN TO AVERT RECESSION



Source: Federal Reserve; E NAR estimates.

The forecast for long-term interest rates is presented in Graph 6. After falling below 9.0 percent for one brief but delightful quarter in early 1987, they immediately shot up by 150 basis points, largely on fears of inflation brought on by uncertainty surrounding the U.S. dollar. Mortgage rates surged again during the summer of 1987, but it took an event like the stock market crash to shake them loose from the 11.0 percent level. Since the market collapse, long-term rates have drifted downward, at first rather quickly, but ultimately much more slowly than their rapid ascension of the spring and summer. The current forecast projects a modest bond market rally through the first half of 1988. The rally could bring 30 year Treasury bond yields down below 8.5 percent, and mortgage rates to below 10.5 percent. Yields are not expected to remain at those levels for long, however. Instead, a stronger economy in the latter half of 1988 could prevent further declines in long-term rates and possibly touch off some modest increases.

GRAPH 6: LONG-TERM RATES COULD MODERATE



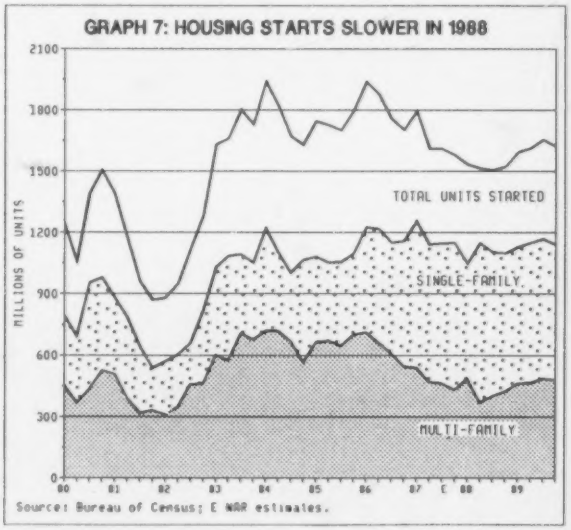
Source: Federal Reserve; E NAR estimates

REAL ESTATE MARKETS

Housing Starts

In November, housing starts posted an annual rate of 1.637 million units, a 7.5 percent increase over the October annual rate of 1.523 million units. However, single-family units were started at an annual rate of 1.119 million units in November, only 1.5 percent faster than the October annual rate of 1.102 million units. The multi-family start rate, which is subject to large fluctuations, rose to an annual rate of 518 thousand units, 23 percent above the October rate of 421 thousand units. The 1988 forecast projects single-family homes to be started at an average annual rate of 1.1 million units, 6 percent below the estimated 1.174 million rate of 1987. Multi-family starts could total 420 thousand units in 1988, 12 percent below the 476 thousand unit pace of 1987. Total housing starts would thus reach 1.52 million units in 1988, 8 percent below the 1987 rate.

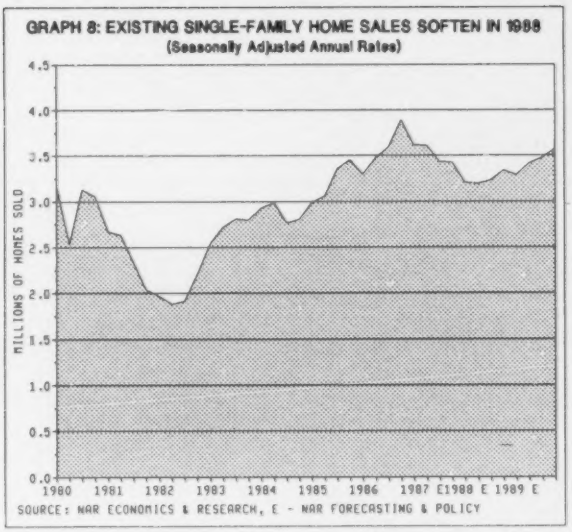
GRAPH 7: HOUSING STARTS SLOWER IN 1988



Source: Bureau of Census; E NAR estimates.

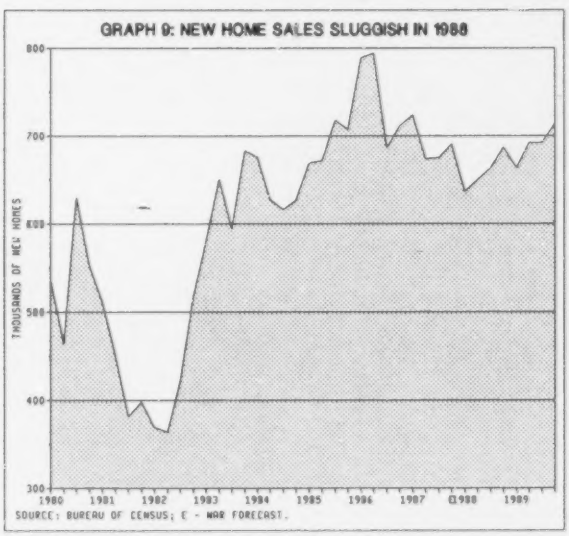
Existing Home Sales

Existing single-family homes were sold at the surprisingly strong annual rate of 3.56 million units in October 1987, the most recent data available. This represented a 3.2 percent gain over the September 1987 rate of 3.45 million units, and a 5.3 percent decline from the 3.76 million unit rate of October 1986. During the first 10 months of 1987, existing homes were sold at the average annual rate of 3.55 million units. Home sales increased in every region of the country during October 1987, but the 10.5 percent gain in the West region was the largest rise. The impact of the stock market collapse may not be observed in the EHS data series until the first quarter of 1988 (see Graph 8), when the combined forces of a weak economy and expectations of even lower interest rates keep many potential homebuyers on the sidelines. Existing home sales could fall to 3.2 million units in the first half of 1988, before rising in the second half for an average annual rate of 3.24 million homes sold in all of 1988.



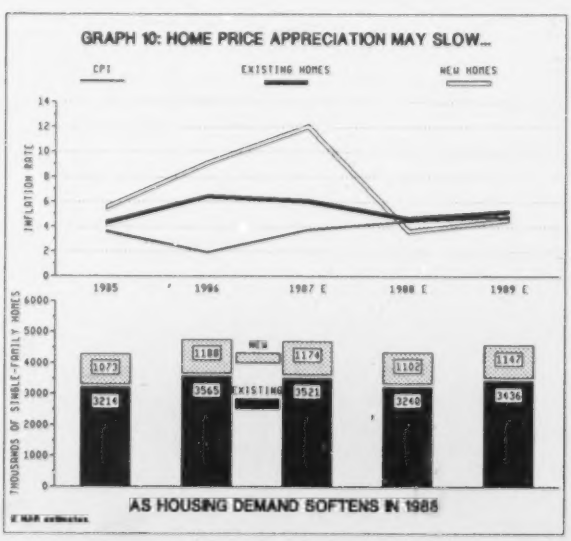
New Home Sales

The annual rate of new single-family home sales (speculative only, not including custom built homes) declined for the second straight month to 657 thousand units in October, the most recent data available. The October rate was 1.5 percent below the September annual rate of 667 thousand units, and 2.7 percent below the October 1986 annual rate of 675 thousand units. Many potential new home buyers have fled the new home market due to high monthly payments brought on by mortgage rate increases in 1987 and a more expensive product supplied by builders. Consequently, existing home sales have reached a 1987 annual rate almost identical to the 1986 level. In contrast, new home sales through ten months of 1987 averaged only 688 thousand units, 8.1 percent below the 1986 rate of 749 thousand units. Graph 9 shows the current forecast which projects new single-family home sales to fall 4 percent in 1988 to 659 thousand units, before rising 5 percent in 1989.



Home Prices

The median existing home price appears to have risen to $85,100 in 1987, a 6.0 percent gain over the $80,300 median price in 1986. Graph 10 presents the current forecast in which a softening in housing demand in 1988 leads to slower price increases. Existing homes should continue to increase in real terms through both 1988 and 1989, a feat new homes will find difficult to duplicate. The 1987 median new home price appears to have risen to about $103,000, a 12 percent increase over the 1986 median new home price of $92,000. New home prices will probably rise by only about 3.6 percent to $106,700 in 1988, due partly to continued weakness in new home sales brought on by the large price increases of 1987. But part of the large 1987 price increase was due to fewer buyers on the lower side of the income spectrum, and more higher income buyers who normally purchase more expensive homes.



TAXING AND SPENDING WASHINGTON STYLE: A Closing View of the FY 1988 Budget Process

by
Frederick E. Flick
Division Vice President
Forecasting and Policy Analysis

This is the season for consumers to be taxing their patience, while spending their money at the long cashier lines in department stores. However, it is also the period just before the Congressional holiday recess and our national lawmakers are taxing and spending as well. Except for the recent Gorbachev - Reagan Summit interlude, the White House and Congress have been focused on calming jittery financial markets since the October 19 stock market crash. In practice, this has become the substantive task of providing a budget for the U.S. Government, and implementing the recent budget accord which provides Fiscal Year 1988 deficit reduction figures which are greater than the $23 billion provided by the Gramm-Rudman-Hollings(GRH)targets.

In this segment of our Real Estate Outlook, we examine the making of the FY 1988 discretionary spending budget, which is expected to be a major influence on the economy and financial markets in 1988. An important part of this influence will be the budget accord, or compromise on spending and taxation worked out between the President and Congress this fall. This deal has been struck to allow circumvention of the Gramm-Rudman-Hollings mandated budget cuts. However, a necessary step was that the president by law had to sign the November 20 GRH sequestration order because Congress and the President could not agree in time on legislation to avoid the required across-the-board expenditure cuts. Through parliamentary maneuvering, Congress still has until mid-December to enact the details of the budget accord and circumvent the automatic implementation of the GRH cuts.

Most importantly, the stock market crash crystallized in the minds of the President and Congress the necessity of supporting compromise legislation that included both spending cuts and tax increases. Prior to this event, the President had repeated his adamant opposition to any legislation involving tax increases. In this case, by accepting some revenue raisers, he was able to obtain a lower cut in defense outlays. Those in Congress who wanted higher levels of non-military spending were able to maintain this through the proposed higher tax collections. Thus, everybody seems to get something out of the agreement.

The Budget Accord

The agreement hammered out by the White House and Congress provides for $30.2 billion in deficit reduction in fiscal 1988 and $45.9 billion in fiscal 1989, with the FY 1989 figures renegotiated as part of next year's budget process. (The GRH sequestrations would have provided only $23 billion in FY 1988.) The accord provides for $9 billion in new taxes in FY 1988 ($14 billion in FY 1989), combined with FY 1988 spending cuts of $5 billion from defense, $2.6 billion from domestic accounts, $4 billion from various entitlements (including Medicare), $2 billion from increased IRS enforcement and user fees, and $6.5 billion from government asset sales and reduced debt service. (See Table 1.)

The Next Steps in the Process

Ultimately, both houses of Congress need to pass, and the President must sign, reconciliation legislation which will incorporate spending (appropriations) and tax provisions that are consistent with the accord. Prior to that final step, the House and Senate each will pass their own versions of tax and spending legislation, with the job of a joint conference committee to reconcile any differences into one package consistent with the accord.

The Progress of the House Budget

On October 29, the House passed a reconciliation bill (involving both taxes and spending), including about $14.3 billion in new taxes, of which $12 billion would be used for deficit reduction.

The most important revenue increase changes in the House tax bill (FY 1988 amounts in parentheses, if available) include:

- 100 percent of the excess of book income or adjusted current earnings over other alternative minimum tax (AMT) income would be a preference for corporate taxpayers. The current 20 percent AMT tax rate would be retained ($2.8 billion);
- Provisions to maintain tax-favored treatment for master limited partnerships in energy, natural resources, and real estate. Income from MLPs that do not engage in active business activities will be considered portfolio income for purposes of the passive loss rules. The partnership level audit rules would apply to publicly offered partnerships ($0.1 billion);
- Limit to $1 million the amount of mortgage principal on which interest payments would remain deductible (less than $50 million);
- Home equity loans on which interest is deductible would be limited to $100,000 for married taxpayers and $60,000 for single filers. Boats and mobile homes used on a transient basis would not qualify as second residences for purposes of the deductions (less than $50 million);

- Limit the deferral of tax liability for like-kind exchange capital gains for real estate to $100,000 annually; and,
- Subject the investment income of Section 501(c)(6) trade associations (i.e., local boards and REALTOR® Associations) to the unrelated business income tax except to the extent that income is set aside for charitable purposes, and except for gain on certain dispositions of assets used in performing exempt purposes.

The October negotiations between the White House and Congress precluded the presence of any revenue loss provisions in any final tax legislation. Since the measure reported out of the House Ways and Means Committee violated this part of the agreement, the reconciliation bill only passed by one vote.

The recently approved House spending bill provides $587 billion to fund the federal government through the end of the fiscal year. However, the provisions on the spending side exceed the non-military component agreed to in the budget accord by more than $2.6 billion. Furthermore, the amount of military spending in the bill is $1.1 billion less than that agreed to in the accord. Thus, there are still these details to be worked out.

The current House passed omnibus spending bill combines 13 separate appropriations bills to fund the government. During the House-Senate joint conference reconciliations, the entire government budget will be worked over to be consistent with the accord's limits of $285.4 billion for military spending and $176.8 for non-military spending in FY 1988.

The Progress from the Senate Side

On October 16, the Senate Finance Committee approved a package of tax increases that would have raised more revenue than eventually negotiated in the accord. However, the events of the next few days, and the reactions of the White House and Congress, caused the Senate to shelve further work on taxing and spending. By December 3, the Senate Budget Committee had produced a reconciliation bill and the Senate Finance Committee had passed a $9 billion package of tax increases for FY 1988. Separately, the Senate Appropriations Committee, on December 3, approved an omnibus discretionary spending bill for $600 billion in FY 1988 which would account for $7.6 billion in budget savings.

By December 10, the Senate had approved the budget accord provisions and, at that point, the combination of the Budget, Appropriations, and Finance Committee's bills were put into a reconciliation bill that would cut $33.7 billion from the projected fiscal 1988 deficit.

A further confounding influence on this side of the process involves the White House's concerns with some aspects of the Senate reconciliation bill. The Administration endorsed most of the components on the appropriations legislation but still did not like three components relating to rural electrification loan refinancing, reductions in farm-subsidy loan rates, and reinstatement of the fairness doctrine for broadcasting. At this point, however, there were not major real estate problem areas in the Senate approved taxing and spending bill.

The Senate Reconciliation Bill

The Senate bill involves a $9 billion tax increase, and would provide for $26 billion in deficit reduction in FY 1988. The tax and spending bills combined would reduce the deficit by $33 billion - $3 billion more than the accord calls for. Furthermore, the spending bill would provide $6 billion in savings from a variety of federal programs, including $2 billion from Medicare, $1.2 billion in farm subsidies, and $1 billion in veterans loan programs.

The tax component of the bill would raise $9 billion in revenue through minor corporate tax increases and the closing of an estate tax loophole related to employee stock ownership plans (ESOPs). Specific major provisions of the budget reconciliation bill include:

- The telephone excise tax would be extended for three years, for a gain of $3.6 billion over the next two years;
- The corporate estimated tax payment rules would be changed to raise $2.3 billion over the next two years;
- The 1986 Act's ESOP/estate tax loophole would be closed for a gain of $2.7 billion over the next two years;
- Repeal of the installment method of accounting for dealers; restoration of the pre-1986 installment sales provisions for non-dealers to yield increased revenues of $4.6 billion over the next two years;
- Freeze the estate and gift tax at the top rate of 55 percent, rather than allowing it to fall to 50 percent next year (less than $50 million);
- Corporate deductions for additions to vacation pay reserves would be disallowed for a two-year revenue gain of $3.9 billion.

(See Table 2, for provisions common to both bills.)

Where It All Stands

The Congress should complete the joint House-Senate Conference reconciliation by late-December just in time for the holidays. Of course, this legislation is for fiscal 1988, which began almost three months ago. Although the conference agreement may project savings for FY 1989 as well, specific items will be renegotiated next year at about this same time.

Regarding the real estate industry, the worst tax provisions are in the House reconciliation measure. These include:

- Placing a $1 million cap on the principal against which mortgage interest would be deductible;
- Loss of deferral to tax liability on the gain from like-kind exchange of real property;
- Restrictions on home equity loan interest deductibility; and,
- Provisions subjecting trade association net investment income to the unrelated business income tax.

As the House-Senate Conference works to resolve these issues, the Administration will still be pressing for changes in programs and policies, but these will have relatively minor effects on the goals worked out in the budget accord.

It appears likely that, by the end of the calendar year the Congress will provide the President with a completed budget. But this is far from the end: the FY 1989 process will begin anew in early spring. After a short hiatus between New Year's and Super Sunday, the bureaucrats and politicians will be gearing up for the FY 1989 process. Thus, taxing and spending Washington style is an on-going feature of life in the shining city on the hill.

Table 1
A COMPARISON OF REVENUES AND SPENDING CUTS FROM THE BUDGET ACCORD VERSUS GRAMM-RUDMAN

	BUDGET ACCORD	GRAMM-RUDMAN
REVENUES:		
Tax Increases	9.0	0
User Fee Increases	0.4	0
IRS Enforcement	1.6	0
Refinancing of REA loans*	5.0	0
Pension savings	0.4	0
VA loan fee	0.2	0
VA loan guarantees	0.8	0
Total Revenues	17.4	0
SPENDING CUTS:		
Military programs	5.0	11.50
Domestic programs	2.6	9.48
Entitlement programs		
Medicare cuts	2.0	1.4
Farm subsidies	0.9	0.6
Student loans	0.25	0.02
Government personnel	0.85	0
Interest on federal debt	1.2	0
Total Spending Cuts	12.8	23.0
TOTAL BUDGET SAVINGS	30.2	23.0
	====	====

*Rural Electrification Administration
Sources: Office of Management and Budget and Congressional Budget Office

Table 2
REVENUE ESTIMATES FROM COMMON PROVISIONS IN THE HOUSE AND SENATE TAX BILLS

	FY 1988	FY 1989	FY 1988-90
Accounting			
Repeal completed contract method	0.8	1.5	4.4
Repeal of vacation pay reserve	0.1	0.1	0.2
Amortization of customer base intangibles	0.1	0.1	0.3
Estimated Tax			
Estimated Tax Penalty Relief for 1987	--	--	--
Corporate Estimated Tax Reform	1.8	0.4	2.5
Master Limited Partnerships:			
PortfolioIncome	0.1	0.1	0.4
Corporate Tax Provisions			
Modify computation of earnings and profits for intercorporate dividends and basis adjustments	0.3	0.4	1.1
Limit consolidated return passthrough	0.2	0.4	1.0
Repeal graduated tax rates for personal servicecorporations	0.1	0.1	0.3
Reduction of tax avoidance in certain corporatedispositions	0.3	0.4	1.3
Pensions: Limit funding of overfunded pension plans	0.6	1.8	3.9
Estate and Gift Tax			
Freeze 55 percent tax rate	+	0.2	0.4
ESOP estate tax deduction	1.3	1.5	4.8
Excise Taxes			
Telephone excise tax: 3-year extension	1.3	2.6	6.0
Collection of diesel fuel and special motor fuels taxes on sales to retailers	0.2	0.2	0.6
Employment Taxes			
Railroad Retirement Tax	0.1	0.2	0.5
Extend FUTA repayment tax	0.7	1.0	2.8
Certain User Fees			
Internal Revenue Service	+	0.1	0.2
Bureau of Alcohol, Tobacco, and Firearms	0.1	0.1	0.4
Customs Service	0.3	0.3	1.0
TOTAL	8.5	11.5	32.1

-- Revenue decrease less than $50 million.
+ Revenue increase less than $50 million.

Source: Tax Notes, November 23, 1987, p. 760 (Published by Tax Analysts, Arlington, VA)

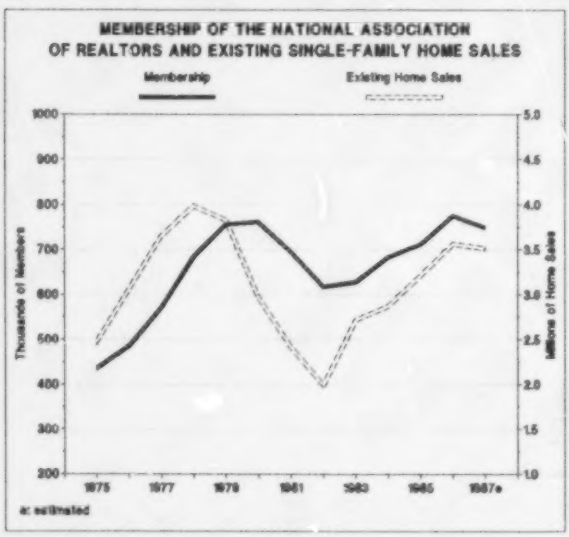
SPECIAL TOPIC:
PROFILE OF REAL ESTATE PRACTITIONERS

There have been significant changes in the profile of the membership of the NATIONAL ASSOCIATION OF REALTORS® over the past three years. These changes are evident in a recently published report entitled Membership Profile 1987. The report is based on a Spring 1987 survey to which more than 2,900 real estate brokers and salespersons responded. Following are some highlights from the report.

Market Conditions at the Time of the Survey Were Good

Real estate markets in general, and single-family home sales in particular, were healthy during 1986 and 1987. At the time of the survey, existing single-family home sales were running at an annual rate in the 3.5 to 3.7 million range, and were well ahead of the nearly 2.9 million homes that were sold in 1984—when the last profile was developed. Similarly, the dollar volume of home sales had grown by almost 60 percent over the same time period. Since residential brokerage is the primary business specialty of more than three-fourths of the Association's members, it is not too surprising that home sales market conditions greatly impact the National Association's membership.

The burgeoning market between 1984 and 1987 attracted many new licensees to the industry. The NATIONAL ASSOCIATION OF REALTORS® shared in this boom. Its membership grew from just under 683,000 at year-end 1984 to almost 744,000 at the time of the survey.



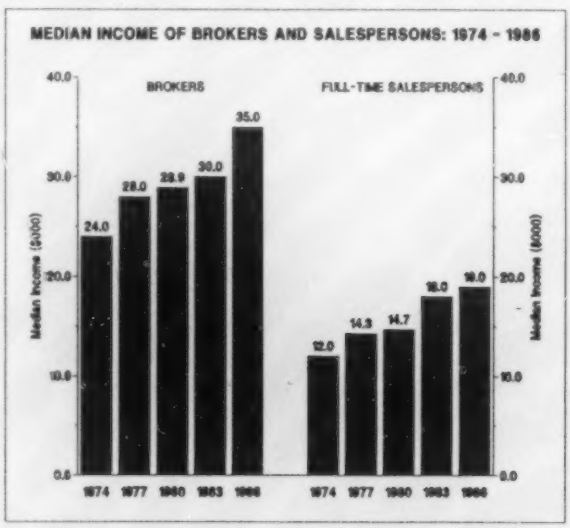
While the Association enjoyed growth in its membership, this growth had its consequences. One major consequence, the entry of so many new sales licensees into the industry, resulted in a very small increase in the average earnings of salespeople. In addition, the median income of salespersons in real dollars dropped between 1983 and 1986, The reason—the lower earnings of this large group of new sales licensees negated income gains made by long-term sales associates. The influence of the new sales licensees also affects other statistics on salespersons.

Another trend which emerged in several parts of the survey is the growing participation of women in real estate. Real estate has traditionally been a profession in which women have been able to compete successfully. The survey found that women now account for a greater proportion of the practitioners than three years ago.

Brokers' Income Up, Full-time Salespersons' Income Little Changed

The impact of improved real estate markets is reflected in the earnings of brokers. In 1986, the median gross personal income of brokers (net of business expenses) was $35,000, almost 17 percent higher than the income reported for 1983. The better real estate market had a different impact on the average earnings of salespersons. A salesperson who worked full time in real estate typically earned $19,000 after business expenses in 1987, six percent higher than in 1983. The small gain in the income of full-time salespersons is due to the lower earnings of newer entrants washing out the gains made by more seasoned veterans of the business.

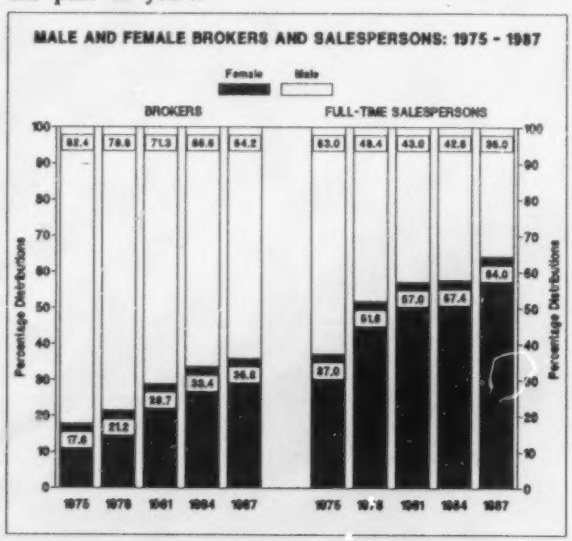
The median income of real estate practitioners compares favorably to the income of people in the U.S. The median income of all persons in the U.S. who are 18 years or older stood at $12,100 in 1986, while the median income of all persons who worked year-round, full-time in 1986 was $21,500.



Role of Women Continues to Grow

At the time of the survey almost 54 million women were in the U.S. civilian work force--43 percent more than in 1975. Furthermore, the proportion of women in the work force grew from less than 40 percent in 1975 to almost 45 percent at the time of the survey.

Similiarly, the real estate industry has experienced a growing proportion of women in the profession. Nearly 36 percent of the brokers in 1987 are female compared to 12 years ago when females accounted for less than 18 percent of brokers. The proportion of female, full-time salespersons has also risen over the past 12 years.



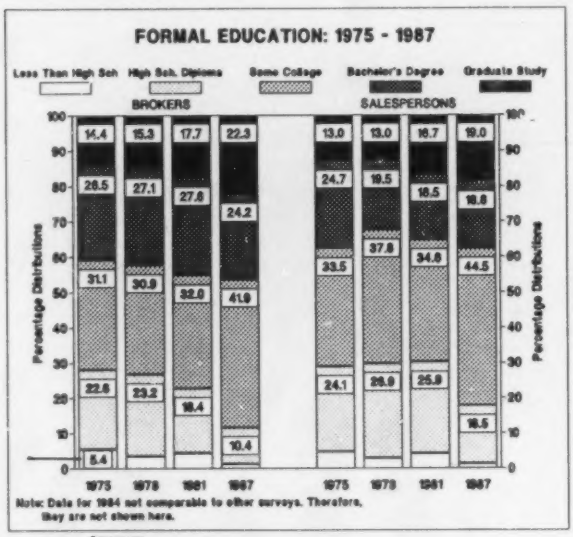
Real Estate Practitioners Are Older than Most Workers

The median age of brokers is 48 years, unchanged from the 1984 survey while the median age of salespersons is 43 years, one year less than in 1984. As a group, real estate practitioners are older than other workers in the U.S. civilian work force who are 18 years or older. The age difference between real estate practitioners and the civilian work force is understandable. Most people do not pick real estate for their first job. The vast majority of real estate practitioners tried their hand at another occupation prior to entering the real estate industry. This explains the older real estate work force.

Educational Attainment Has Improved

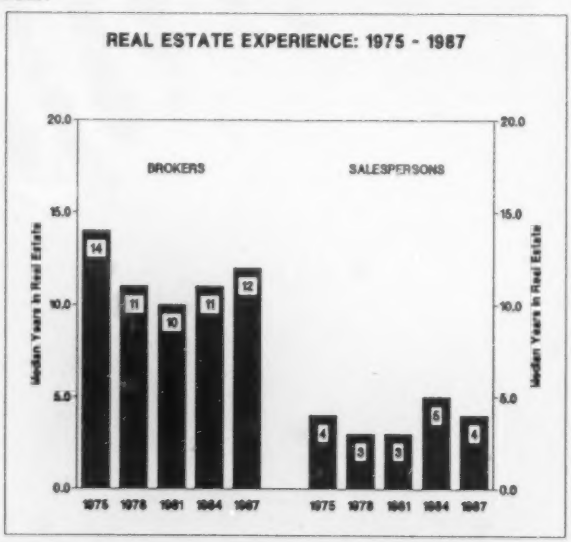
Real estate practitioners are very well educated, and their educational attainment has improved over the years. The percentage of brokers and salespersons with a high school diploma or less has declined while the proportion who have a bachelor's degree or more has increased.

Generally, real estate professionals have completed higher levels of formal education than most U.S. workers. For example, fewer than two out of every ten U.S. workers has a bachelor's degree or more compared to 46.5 percent of brokers and 37.8 percent of salespersons.



Real Estate Experience--Up for Brokers, Down for Salespersons

The real estate experience of brokers has increased since 1981, while the experience level of salespersons has declined. The median years in the business of brokers rose from 10 years in 1981 to 12 years in 1987. Salespersons, on the other hand, have typically been in the business for four years--down from five in the last survey. The latter finding reflects the surge of new sales licensees entering the business.

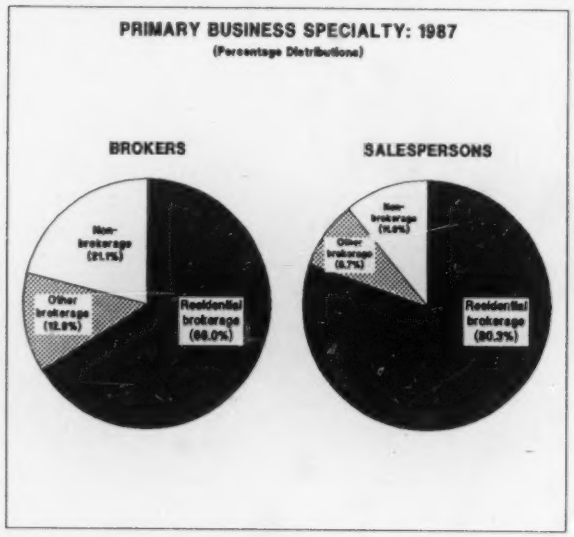


Single-Family Home Sales Is the Main Source of Income

Residential brokerage is the activity in which most members spend at least some of their time. Roughly nine out of every ten brokers and salespersons devote at least part of their time to selling homes.

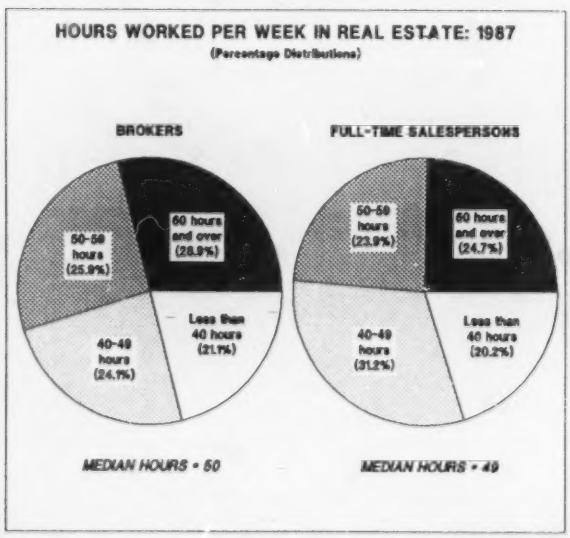
Commercial brokerage, farm and land brokerage, property management, mortgage finance, appraising and counseling are also frequently mentioned activities in which practitioners are involved to some extent.

The importance of home sales to real estate practitioners is further evidenced by the finding that residential brokerage continues to be the primary business specialty of brokers and salespersons. Two-thirds of the brokers and eight out of every ten salespersons list residential brokerage as their bread-and-butter activity.



Real Estate Practitioners Put In Long Hours and Work Weekends

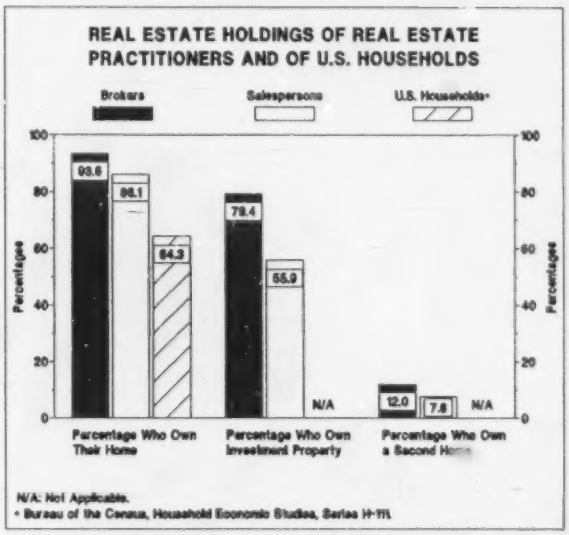
Working in real estate is not a profession for someone who is afraid to put in long hours or work weekends. Brokers work 50 hours a week, on average, but nearly three out of every ten devote 60 or more hours a week to their profession. A full-time salesperson typically spends 49 hours per week on the job, with one-quarter working 60 hours per week or more.



REALTORS® Have a Strong Committment to Homeownership and the Ownership of Real Estate

Real estate professionals practice what they preach. Approximately nine out of every ten brokers and salespersons own the home in which they live. Twelve percent of brokers and slightly fewer salespersons own a second home. More than 79 percent of brokers and just under six out of every ten salespersons own or have an interest in investment real estate which they hold in their personal account.

The rate of real estate ownership is much higher among real estate practitioners than among most American households. A recently released study entitled "Household Wealth and Asset Ownership: 1984" from the Bureau of the Census found that just over 64 percent of all U.S. households own a home. The study also estimates that less than 10 percent of households own rental property and exactly 10 percent own "other" real estate such as second homes for personal use and undeveloped land.



More Detailed Report Also Available

The full report entitled Membership Profile 1987 is available at a price of $12.00 from Catalog Sales, NATIONAL ASSOCIATION OF REALTORS®, P.O. Box 10958, Chicago, Illinois 60610-0958. The full report contains detailed information on the economic, demographic, educational, professional and business backgrounds of real estate brokers and salespersons.

John C. Keaton
Director, Business Studies
Economics & Research Division

January 1988

U.S. ECONOMIC OUTLOOK

	QUARTERS							YEARS				
	Actual		Forecast					Actual		Forecast		
	1987.2	1987.3	1987.4	1988.1	1988.2	1988.3	1988.4	1989.1	1985.0	1986.0	1987.0	1988.0	1989.0
AGGREGATE ECONOMY													
Gross National Product (billions of dollars)	4445	4521	4587	4638	4700	4779	4859	4957	4010	4235	4483	4744	5094
% Change	6.3	7.0	6.0	4.5	5.4	6.9	6.8	8.4	6.3	5.6	5.8	5.8	7.4
% Change (w/out inflation)	2.5	4.1	2.9	1.0	1.5	2.7	2.6	3.5	3.0	2.9	2.8	2.2	2.9
Consumer Price Inflation (CPI)	4.9	3.9	4.4	4.2	4.3	4.5	4.8	5.0	3.6	1.9	3.7	4.4	4.8
GNP Inflation (GNP Deflator)	3.5	2.8	3.1	3.4	3.9	4.2	4.1	4.7	3.2	2.6	3.0	3.5	4.4
Unemployment Rate - Civilian	6.2	6.0	6.0	6.1	6.3	6.3	6.3	6.2	7.2	7.0	6.2	6.2	6.1
Civilian Employment-Household Basis (millions)	112.2	112.9	113.3	113.6	113.9	114.2	114.6	115.1	107.2	109.6	112.4	114.1	115.8
Percent change	3.4	2.4	1.5	1.2	0.9	1.3	1.3	1.8	2.0	2.3	2.5	1.5	1.5
Manufacturing Capacity Utilization	80.5	81.4	82.0	82.3	82.0	82.0	82.0	82.3	80.1	79.7	80.9	82.1	82.2
Domestic Auto Sales	7.0	8.0	5.8	6.2	6.5	6.9	7.1	7.0	8.2	8.2	6.9	6.7	6.9
Federal Tax Receipts (NIPA) as % of GNP	20.8	20.4	20.1	20.1	20.1	20.1	20.3	20.6	19.7	19.5	20.3	20.1	20.6
Federal Expenditures (NIPA) as % of GNP	23.9	23.4	23.9	23.7	23.5	23.4	23.4	23.2	24.6	24.4	23.8	23.5	22.9
Deficit(NIPA)	-139.2	-137.2	-172.7	-170.9	-158.2	-157.4	-151.8	-125.1	-196.0	-204.7	-154.9	-159.6	-119.4
as % of GNP	3.1	3.0	3.8	3.7	3.4	3.3	3.1	2.5	4.9	4.8	3.5	3.4	2.3
REAL ESTATE MARKETS													
HOME SALES													
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4718	4542	4542	4221	4309	4301	4404	4383	4254	4717	4659	4309	4548
Percent change -- year ago	1.3	-3.4	-9.4	-12.7	-8.7	-5.3	-3.0	3.8	8.6	10.9	-1.2	-7.5	5.6
Existing Single-family Home Sales (thousands)	3610	3430	3426	3203	3194	3228	3336	3287	3214	3565	3521	3240	3436
Percent change -- year ago	3.8	-4.4	-11.9	-11.5	-11.5	-5.9	-2.6	2.6	12.1	10.9	-1.2	-8.0	-8.0
Housing Starts (thousands)	1612	1610	1582	1536	1518	1507	1526	1593	1742	1819	1650	1522	1620
Percent change -- year ago	-14.2	-8.4	-7.1	-14.4	-5.8	-6.4	-3.5	3.7	-1.4	4.4	-9.3	-7.7	6.5
Single-Family Units	1142	1147	1151	1050	1150	1106	1101	1129	1073	1188	1174	1102	1147
Percent change -- year ago	-6.2	-0.3	-0.7	-16.4	0.7	-3.5	-4.3	7.6	-2.4	10.8	-1.2	-6.1	4.1
Multi-Family Units	470	463	431	486	369	401	425	464	670	631	476	420	474
2-4 Family Units	73	57	53	60	46	50	53	57	93	85	66	52	59
Percent change -- year ago	-9.9	-25.2	-39.4	-24.8	-37.5	-13.4	-1.4	-4.6	-23.3	-8.6	-22.8	-21.1	12.7
5+ Family Units	397	406	378	426	323	352	372	407	576	546	410	368	415
Percent change -- year ago	-31.6	-23.6	-17.2	-7.2	-18.6	-13.4	-1.4	-4.6	5.5	-5.3	-24.9	-10.1	12.7
New Single-family Home Sales (thousands)	674	675	665	637	650	663	687	664	692	745	685	659	690
Percent change -- year ago	-15.1	-1.6	-6.5	-11.9	-3.6	-1.7	3.3	4.2	8.3	7.7	-8.1	-3.7	4.7
Mobile Homes Shipped (thousands)	227	241	241	232	246	244	245	251	283	249	236	242	257
HOME PRICES													
Existing Home Prices - Median ($1000)	85.1	85.5	85.5	86.0	87.5	90.5	92.0	92.8	75.5	80.3	85.1	89.0	93.6
Percent change -- year ago	3.7	5.9	6.6	2.1	2.9	5.9	7.6	7.9	4.3	6.4	6.0	4.6	5.2
New Home Prices - Median ($1000)	103.5	107.2	104.0	106.0	106.6	107.3	106.8	108.0	84.3	92.0	103.0	106.7	111.5
Percent change -- year ago	12.5	14.6	9.4	8.9	3.0	0.1	2.7	1.8	5.5	9.1	12.0	3.6	4.5
FINANCIAL MARKETS													
Long-Term Interest Rates													
30-year Fixed Rate Mortgage (FHA Secondary)	10.3	10.7	10.7	10.6	10.5	10.6	10.6	10.3	12.2	9.9	10.1	10.6	10.4
1-year ARM (without buydown)	8.1	8.3	8.2	8.4	8.3	8.2	8.2	8.1	7.6	7.9	8.2	8.3	8.1
Corporate AAA Bond Rate	9.7	9.8	10.1	9.6	9.4	9.5	9.5	9.5	11.4	9.0	9.3	9.5	9.6
Government Bond Rate	8.6	9.1	9.1	8.5	8.3	8.4	8.5	8.5	10.8	7.8	8.5	8.4	8.7
Short-Term Interest Rates													
Federal Funds Rate	6.7	6.8	6.9	6.5	6.4	6.6	6.7	6.8	8.1	6.8	6.6	6.5	7.0
3-month T-Bill Rate	5.7	6.0	5.8	5.4	5.3	5.4	5.5	5.5	7.5	6.0	5.8	5.4	5.7
Prime Rate	8.0	8.4	8.7	8.4	8.1	7.7	7.6	7.6	9.9	8.3	8.2	7.9	7.9
Discount Rate	5.5	5.7	5.8	5.5	5.5	5.5	5.5	5.5	7.7	6.3	5.6	5.5	5.5
Money Supply (M1)(% change)	6.5	0.0	8.5	7.8	7.9	7.3	6.4	6.9	9.1	13.3	11.5	6.7	6.6
Value of the U.S. Dollar (Trade-Weighted Avg.)	97.0	98.7	93.0	89.8	88.6	87.6	86.4	86.2	143.2	112.3	97.1	88.1	85.6
Percent change	-11.1	7.2	-21.1	-12.9	-5.3	-4.7	-5.1	-1.0	3.5	-21.6	-13.5	-9.3	-2.9

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.

REAL ESTATE

Vol. 1, No. 2

OUTLOOK

February 1988

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- Fourth quarter real (inflation-adjusted) GNP growth was reported at an annual rate of 4.2 percent. The fourth quarter GNP advance was almost exclusively based upon inventory accumulation and net export growth. In contrast, the 4.3 percent annual rate of third quarter real GNP growth was due largely to consumer spending, net export growth and equipment spending by business.
- Real GNP growth in the first quarter of 1988 is expected to slow to an annual rate of 1.0 percent as businesses work off their uncomfortably high stocks of inventories. Weak consumer demand will complicate the effort to sell off inventories, placing much of the burden of first quarter growth on the export sector. In 1988, real GNP growth is expected to slow to a rate of 2.3 percent on a year-over-year basis.
- Consumer price inflation in 1987 accelerated moderately to 3.7 percent when measured on a year-over-year basis. Consumer prices are in no danger of rising out of control in 1988, given the current forecast of slow growth. Consumer prices are expected to rise 4.1 percent in 1988 on a year-over-year basis.
- Short-term interest rates are expected to fall slightly in the first half of 1988, as the monetary authority works to keep the economy from slipping into a recession. Long-term interest rates could also benefit from the slow growth expected in the first two quarters of 1988. A mild bond market rally could help push mortgage interest rates down in the first half, before renewed economic growth in the second half contributes to some firming in interest rates.
- Sales of existing single-family homes reached 3.52 million units in 1987, only 1.3 percent below the 1986 rate of 3.57 million units. Existing single-family homes are expected to be sold at an annual rate of 3.19 million units in the first half of 1988, before strengthening to an annual rate of 3.26 million units in the second half.

IN THIS ISSUE

- **Economic Commentary: THE CRUELLEST MONTH, by John A. Tuccillo**
- **Outlook for the Economy and Real Estate, by Sean A. Burns**
- **Secondary Market Outlook, by Mary A. Fruscello**
- **Update on the FY1988 Budget Process, by Frederick E. Flick**
- **Special Topic: Foreign Investment in U.S. Real Estate**

Forecasting & Policy Analysis Division
NATIONAL ASSOCIATION OF REALTORS ®
REALTOR® 777 14th Street, NW Washington, D.C. 20005

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THE CRUELLEST MONTH:

Economic Commentary

by
John A. Tuccillo
Chief Economist and
Senior Vice President
Real Estate Finance

February made me shiver
With every paper I'd deliver
Bad news on the doorstep;
I couldn't take one more step
-- Don McLean, "American Pie"

Eliot was wrong; February is the cruellest month. Just when you've had enough of winter -- enough cold, enough snow, enough darkness --along comes the coldest, snowiest and darkest of months. Along comes the shortest month that seems to last for thirty-five or thirty-six days instead of twenty-eight or twenty-nine. Along comes the real winter. February is a time without a saving grace -- no holiday merriment, no promise yet of spring and sun and warmth. It is a time that must be endured against the (almost) certain prospect that better days will come. Look around: everyone may be wishin' and hopin', but they're all just trudgin' and copin'.

The economy also has a case of the Februaries: consumer spending survived through the holidays, but with an increase (0.7 percent) that was not quite up to snuff; January auto sales were well above 1987, but that was a disappointing month; the trade figures are significantly better, but it could be a seasonal fluke; GNP will grow by over two percent this year but at only half that rate in the first six months. In other words, the news is not bad, but it's not good enough. We have reached an unfortunate intersection. Housing and consumer spending, which had paced this expansion, have fallen back into the pack and no new leader has emerged. In fact, during the coming year, we will see exports stimulate industrial production and lead the economy. But for now, we appear to be drifting, uncertain because of financial markets and worried about the international economy. In short, this is a time when neither optimism nor pessimism is clearly warranted.

For housing, this is a time to catch a second wind. During the past two years (1986 and 1987), we sold over 7 million existing homes. Of the past ten years, these were the two best. Additionally, housing starts over the last 24 months have been very strong for the fifth and sixth years of a housing expansion. Right now, the rate of starts is 80 percent above the low point that began the expansion. No other post-war cycle was as high at this age; no other cycle was still in expansion at this age. In short, we have come through a period of housing intensity that must inevitably yield to a more gentle pace.

Accordingly, this year will not be as good a year for housing as was 1987. Right now, we expect existing home sales to decline to 3.22 million units (an 8 percent decline), new home sales to total 660,000 (down 3 percent) and starts to fall to 1.54 million (from 1.64 in 1987). The multifamily sector in particular will be weak during 1988. Currently, we can absorb 400,000 multifamily units through existing demand. But the sector as a whole is overbuilt, suggesting that multifamily construction must fall well below 400,000 units if the market is to achieve some semblance of equilibrium.

Like the economy, housing will look much better the farther we move from the dread February. Because interest rates will rise, and then fall (election economics kick in about May), housing activity will grow through the year and be strongest in the second half. The structure of the population is a real plus for the housing sector and the demand for homeownership will be strong. As 1988 matures, and rates fall, this demand will assert itself. Moreover, house price appreciation will moderate during 1988, with both existing and new home prices rising by about 4 1/2 percent.

The wild card in this whole picture is still the dollar. Intervention by the world's central bankers, regardless how massive, cannot maintain the dollar at value levels unjustified by economic fundamentals. We ought to see a continuation of the good trade figures unveiled in January. On the optimistic side, a $30-40 billion reduction in the trade deficit could occur in 1988. But if there is no improvement in the deficit, the dollar could go into free fall and set off the stagflationary forces that dogged this economy in the late 70's.

So, even the international picture has a February kind of look. We know the days are getting longer, we know spring is coming, but we have no hard, definitive evidence that our hopes and assumptions are indeed reality. In short, we are in a month with little redeeming value. Oh well -- at least I've kept my new year's resolution: I have not yet eaten anything with suction cups, even if it's raw.

Outlook for the Economy and Real Estate

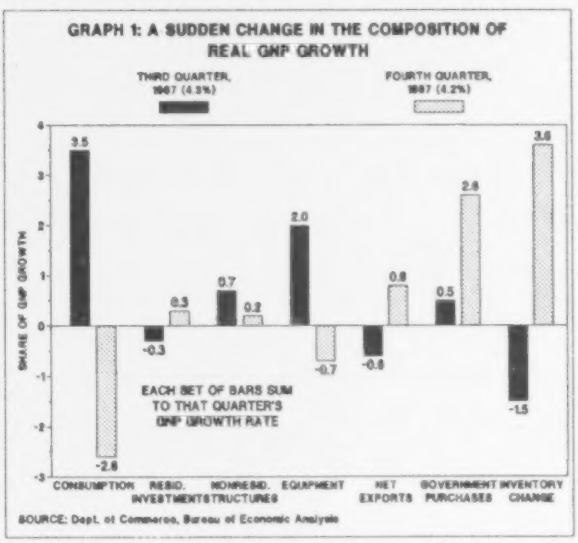
According to most economic indicators, the longest peacetime expansion on record has yet to stumble, although there are several reasons to be cautious that the end to the boom may indeed be in sight. At the time this issue went to press, the government had just released its estimate of the fourth quarter annual rate of real (inflation-adjusted) GNP growth. This preliminary estimate showed that real GNP growth reached an annual rate of 4.2 percent in the final quarter of 1987, virtually identical to the 4.3 percent annual rate of the third quarter. However, no two identical growth rates may have ever been more different (see below). In 1987, real GNP rose 2.9 percent when measured on a year-over-year basis, and by 3.8 percent from the fourth quarter of 1986 to the fourth quarter of 1987.

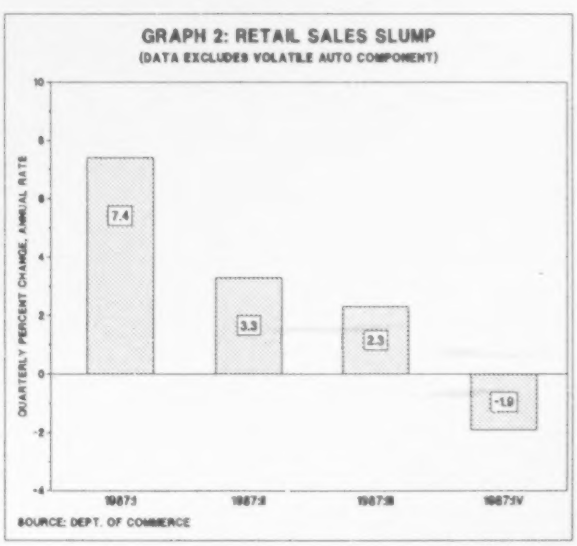
Accompanying the GNP report was news that the GNP deflator (a broad measure of inflation) rose at an annual rate of only 2.7 percent. While the rate was only marginally below the 2.8 percent rate of the third quarter, the report came at a time when inflation worries were on the rise. Fear of potentially harmful high rates of inflation were touched off by a sharp decline in the value of the U.S. dollar in December, and expectations that import prices were on the verge of pushing up domestic consumer prices. However, the data on consumer prices does not seem to bear this out. When measured from December 1986 to December 1987, consumer prices rose 4.4 percent. While this rate was more than double the 1986 pace, it is well within the limits experienced in past economic expansions. In addition, the January announcement of a large decline in the monthly merchandise trade deficit for November (due to strong export growth) has eased the run on the dollar.

Changing Composition of GNP Growth

The composition of these two estimates paint two strikingly different pictures of the economy (see Graph 1). The third quarter rate of expansion came on the strength of consumer spending, export growth, and related equipment purchases by manufacturers in the midst of re-tooling efforts to respond to the export boom. These advances in final sales were offset to a small degree by a decline in inventory investment in the third quarter. Disaggregating the fourth quarter data in the same manner shows that fourth quarter final sales were almost flat, as declines in consumer spending offset gains in other components. If the annual fourth quarter purchases of the government's Commodity Credit Corporation are netted out from the GNP data, then final sales actually declined in the fourth quarter. In contrast, inventory investment accounted for virtually all of the fourth quarter gain. Inventory accumulation at the manufacturing level is explained by faster growth in export demand. But inventory accumulation at the wholesale and retail levels will have to be sold off in 1988, setting the stage for production cutbacks in the first quarter.

A closer look at the trend in consumer spending during 1987 better explains the sudden transformation in the composition of GNP growth. The fall-off in consumer spending was evident in the mixed performance of retail sales in the fourth quarter. Retail sales ended the quarter on a positive note with a 0.7 percent advance in December. However, one month does not a quarter make, as a large decline in October and a negligible change in November paced fourth quarter retail sales to a slower rate than in the previous quarter. Graph 2 shows the steady decline in retail sales (excluding the auto component) throughout 1987, indicating that the present weakness in consumption is not due wholly to the October stock market crash.





THE ECONOMIC OUTLOOK

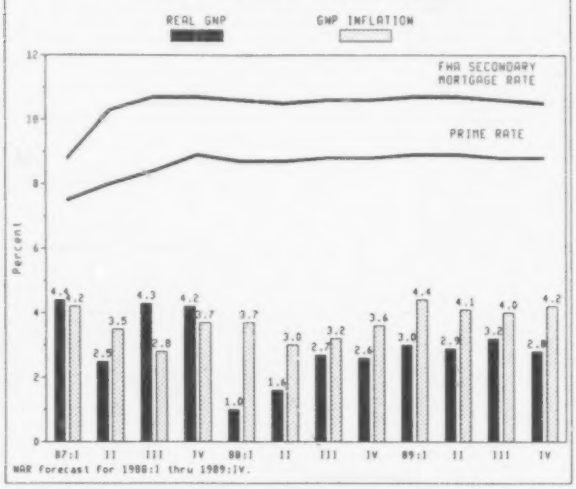
The fourth quarter GNP report implies that the economy will continue to move forward, but at a slow rate in the first quarter of 1988 (see Graph 3). The reasoning for this goes as follows. The buildup in inventories in the wholesale and retail trade industries will undoubtably force a slowdown in production during the first quarter. All indications are that the American consumer will spend the quarter buying back his debt and not new products. Offsetting this (and to what degree remains the question) will be continued growth in exports and renewed equipment spending by export-related industries. Inflation should remain under control given slack domestic demand and debt-conscious consumers who will likely curb their appetite for increasingly expensive imported goods. Both long- and short-term interest rates could slide back a bit in the first half of 1988, if reports of a slow economy ring true. The current forecast for first quarter real GNP growth remains unchanged from the January forecast of 1.0 percent. For the year, real GNP is expected to rise 2.3 percent above its 1987 level.

In apparent contradiction to this forecast for slower growth, industrial production has been rising steadily (Graph 4). Since the latter half of 1986, industrial production has mounted a comeback, rising 5.2 percent in 1987 alone. However, manufacturers reported using 82.1 percent of their capacity in December, meaning that less and less capacity remains to produce goods for export. For capacity-constrained industries like chemicals and paper, expanding their existing capacity to meet higher export demand is critical. However, many businesses have just emerged from difficult layoffs and plant closings, and are understandably reluctant to expand their capacity this early in an export boom. The upshot is that while industrial production needs to remain high to help avoid a stagnant economy, capacity limits are being reached in many industries which could lessen the expected boost to the economy from an expansion in exports.

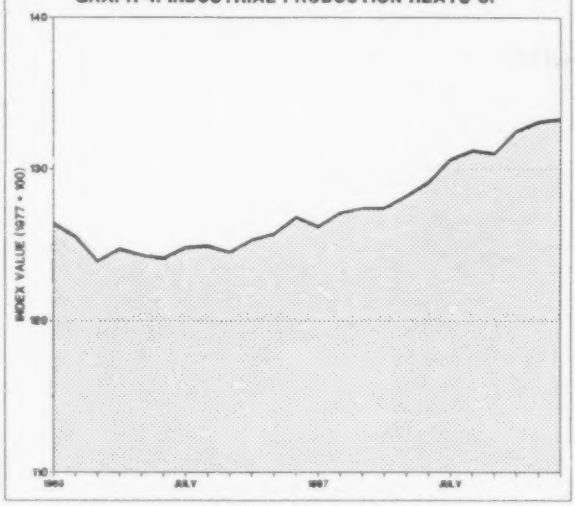
Monetary Policy and Interest Rates

Faced with uncertain strength in the economy and international investors alternatively pleased and displeased with holding dollars, the Federal Reserve has a difficult task in carving out an effective monetary policy in 1988. At the time of the stock market crash, the Fed wisely pumped liquidity into the economy to meet the demand for cash and equivalents. Satisfied that the economy was not on the brink of collapse, the Fed appears to have since tightened up on monetary policy which has stabilized interest rates. The fourth quarter GNP report could prod the Fed to ease up on monetary policy so that the economy continues to grow through the first half of 1988. To that end, this forecast retains the assumption of the January forecast that the Fed nudges short-term rates down in the first half of 1988 (Graph 5). Assuming economic growth heats up in the second half of the year, the Fed is assumed to tolerate only a slight rise in rates in the face of the November elections.

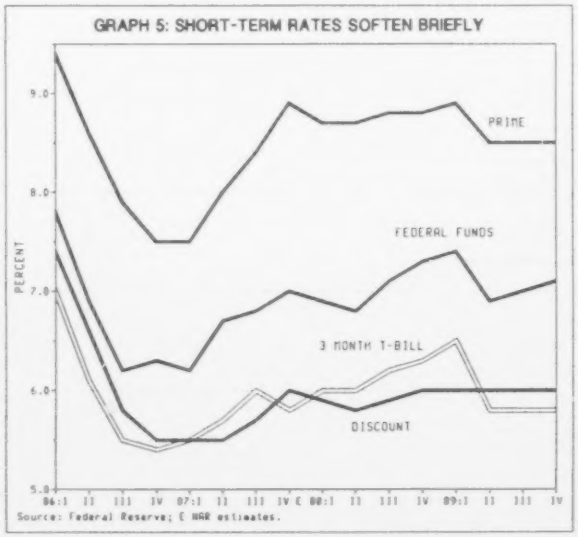
GRAPH 3: THE ECONOMIC OUTLOOK



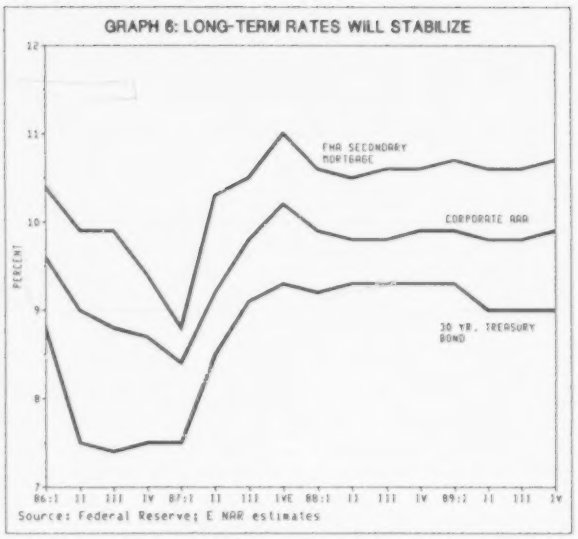
GRAPH 4: INDUSTRIAL PRODUCTION HEATS UP



GRAPH 5: SHORT-TERM RATES SOFTEN BRIEFLY



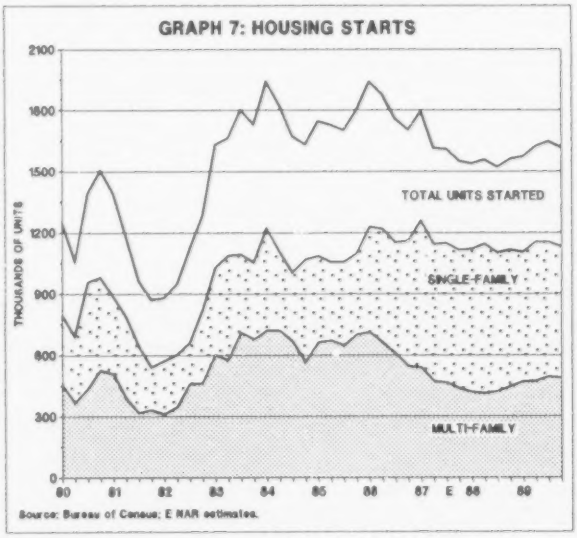
Long-term interest rates have fluctuated in a narrow band in recent months. The fourth quarter GNP report could likely touch off a bond market rally that would move long-term rates out of this tight band. Such a rally could keep long-term rates down through the first half of 1988 (Graph 6). The potential exists for long-term rates to remain at these reduced levels through the second half of 1988 as well. However, the latter half of 1988 poses some risk for a slight rise in long-term rates if economic growth is buoyed by strong export growth and the return of the American consumer. In 1987, the interest rate on a 30-year fixed rate mortgage sold in the secondary market was 10.0 percent. However, the year just finished had its ups and downs with respect to long-term rates, ranging from 8.8 percent in the first quarter to 11.0 percent in the final period. More stability is expected in 1988, with rates not expected to test the lows of the first quarter of 1987. Mortgage interest rates are expected to average above 10 percent throughout 1988, despite the slow growth environment. This is partly due to our dependence on foreign capital to satisfy our domestic capital needs.



REAL ESTATE MARKETS

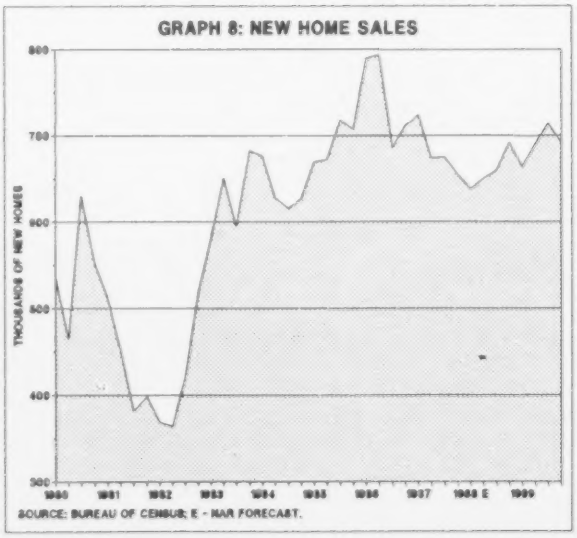
Housing Starts

Total single-family housing starts declined to an annual rate of 1.374 million units in December, a 16 percent decline from the November annual rate of 1.639 million units. Compared to December 1986, total housing starts were down by 24.2 percent. Single-family homes were started at an annual rate of 1.023 million units in December, 7.8 percent below the November annual rate of 1.11 million units. Multi-family units accounted for more of the decline, falling to a December annual rate of 351 thousand units, down 33.7 percent from the November annual rate of 529 thousand units. Total starts fell in all regions of the country, with the West experiencing the largest drop: more than 26 percent. In 1988, housing starts are expected to continue on this downward trend, falling 6 percent in 1988 (Graph 7). Single-family starts could total 1.12 million units in 1988, almost unchanged from 1987.



New Home Sales

The annual rate of new single-family home sales in November fell to an annual rate of 664 thousand units, 1.2 percent below the revised October annual rate of 672 thousand units. The eleven month average for new home sales through 1987 is 685 thousand units, three percent above the November annual rate. For comparison, in 1986 total single-family home sales reached 750 thousand units. In 1988, new home sales are expected to reach 660 thousand units, a 3.3 percent decline from the 1987 expected total of 682 thousand units (Graph 8). Weakness in the economy and very high prices will discourage some consumers from buying a new home, leading them to consider existing homes as an affordable alternative.

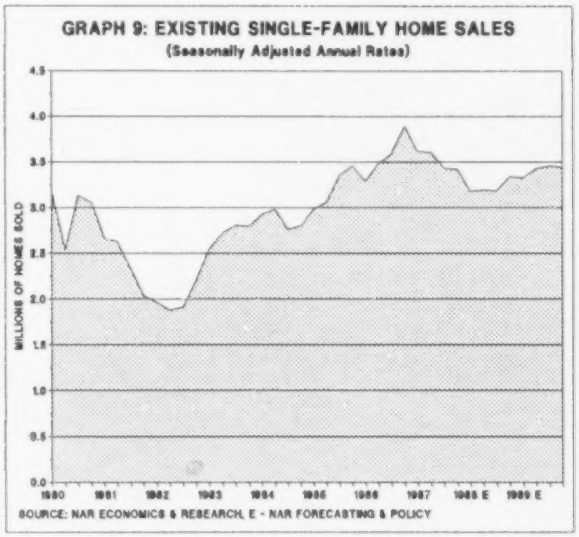


Existing Home Sales

Existing single-family homes were sold at an annual rate of 3.28 million units in December, a 3.8 percent decline from the November annual rate of 3.41 million units. For the year, existing home sales totaled 3.52 million units, just 1.3 percent below the 1986 total of 3.565 million units (Graph 9).

All regions registered a drop in existing home sales rates during December. Existing home sales in the Midwest region declined 8 percent to an annual rate of 810 thousand units, sales in the Northeast fell 4.5 percent to an annual rate of 630,000 units, the West was off 1.7 percent to a 580,000 unit pace, and the South edged down by 1.6 percent to a 1.26 million unit pace. These declines do not so much foreshadow a large scale retreat as they suggest the housing market is, after two very strong years, taking a breather of sorts. During 1986 and 1987, more than 7 million existing homes were sold, by far the strongest two year sequence of the 1980's.

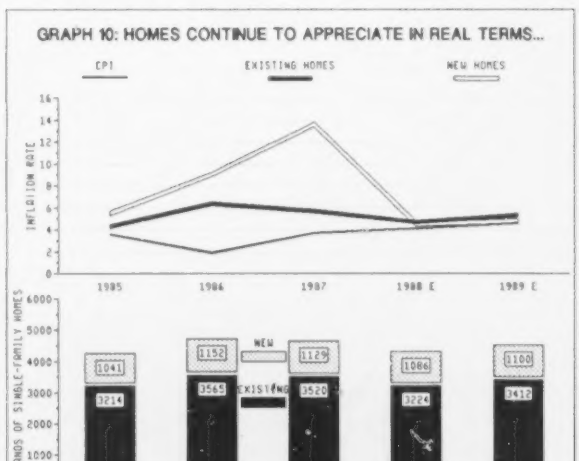
In 1988, sales of existing single-family homes are expected to decline 8.4 percent to 3.224 million units. Strength in existing home sales is expected to build throughout the year. A sluggish economy in the first half will hold existing home sales to an annual rate of about 3.19 million units over the first six months. As economic growth returns in the second half, existing home sales are expected to increase to a 3.26 million unit rate during the second six months.



Home Prices

The value of both existing and new homes continued to appreciate in real terms during 1987 (Graph 10). For the year, the median existing home price rose to $84,900, a 5.7 percent increase over the 1986 median existing home price of $80,300. Through the eleven months of 1987 for which there is data, the median new home price rose to $104,200 in 1987, a 13.3 percent gain over the 1986 median new home price of $92,000. Since the interest rate rise in the Spring of 1987, new home prices have skyrocketed. This peculiar relationship seems to be reflecting the fact that those persons still capable of purchasing a new home after the interest rate rise of 1987 tend to be higher earning individuals who are purchasing larger homes. Therefore, the sample of new homes used in the statistic is being skewed toward the more expensive end of the new home spectrum.

In 1988, both existing and new homes will continue to appreciate in real terms, but new home prices are expected to appreciate at a markedly slower rate than their 1987 rise. The median existing home price should rise by about 4.7 percent in 1988 to about $88,900. The median new home price is expected to rise by about the same amount, 4.5 percent, and reach an annual average of $109,200.



Sean A. Burns
Research Economist
Forecasting & Policy Analysis Division

Secondary Market Outlook

by
Mary A. Fruscello
Division Vice President
Real Estate Finance

For the mortgage markets, 1987 was in many respects the best of times and the worst of times. In retrospect, that twelve month period was a microcosm of much of both the good and bad that the market can experience. Unfortunately, the outlook for 1988 appears to promise more of the same "blessing" of interesting times.

The record loan demand of the early part of the year that delayed processing of loan applications, frustrating borrowers and delaying closings, eventually slacked off. Much to their surprise, lenders who were still staffing up heavily in the spring found volume dropping substantially by the third quarter. The heavy demand for refinancing was over, and when the dust settled, applications for purchase money mortgages were not strong. By early 1988, the mortgage pipeline overflow of May had become the trickle of January. Mortgage bankers who were desperately raiding competitors for experienced personnel nine months ago have instituted extensive layoffs.

The drop in loan activity is reflected in the secondary market. Issuance of pass-through mortgage backed securities (Fannie Mae MBSs, Freddie Mac PCs and Ginnie Maes) has declined steadily since summer, and sharply since October. Salomon Brothers estimates November issues at $10.6 billion, less than half the $22.6 billion issued in July. Freddie Mac reports commitment volume through its open window programs (i.e., programs under which it issues commitments to buy loans directly from lenders) has dropped from approximately $760 million in June to nearly $60 million in November.

Of course, a key reason for the drop in mortgage backed security volume is the dramatic change in product mix since summer. ARMs have become the mortgage of preference for an increasing number of homebuyers. As a result, the supply of fixed rate mortgages has declined, reducing the "raw material" for the bulk of mortgage backed pass-through trading.

For the most part, ARMS are being held in portfolio by thrift originators or sold by mortgage bankers directly, rather than in security form. Both Fannie Mae and Freddie Mac have stepped up their efforts to increase investor interest in ARMs securities, emphasizing investment quality and reduced servicing problems compared to direct investment in ARM mortgages.

The market's response to the agencies' attempts to stir up enthusiasm for these securities has been underwhelming. The dearth of significant trading volume continues, and pricing is not favorable compared to direct sale of the loans, even through the agencies' direct purchase programs.

One area where there has been some activity in ARMs securities has been in privately negotiated transactions with Fannie Mae and Freddie Mac. Some large lenders have obtained agreements to convert huge blocks of adjustable mortgages to security form, for subsequent sale in the secondary market. Many of these loans are tied to the Federal Home Loan Bank Board 11th District Cost of Funds index, which has become popular with investors because it tends to lag the market when rates decline. Securities backed by these loans have had some trading activity.

There is also some indication that these negotiated transactions are being structured to permit greater lender flexibility in underwriting, while maintaining eligibility for securitization. This may be good news for homebuyers. Underlying security structure, with guarantees as to loan quality, may be used by lenders to offer more attractive qualifying terms to borrowers. Lenders have great motivation to do so, as they attempt to improve their share of what many project will be a smaller volume market this year.

Ironically, the reduced supply of all mortgage backed securities has had a dampening effect on yields. This softening has been reflected not only in the primary market, as rates have come off their pre-October levels, but also in the December prepayment rates for securities, which surprised analysts by increasing for almost all coupons. Rates may come off even more with the unexpected low trade deficit announced in January.

There is great uncertainty in the secondary market, however, about the long term outlook for mortgage rates. Although higher prepayments and low volume may indicate continued downward pressure, analysis of recent security pricing shows some signs that investors expect higher rates in the future. For example, securities prices have risen in recent weeks, as rates have declined. But changes in pricing on discount (below par) securities and premium (above par) securities have been unequal--recent price increases have been as much as one point greater for the latter. This change in the relative pricing of these securities suggests that investors in above market coupon securities expect prepayments to slow in the future, making premium securities a relatively more attractive investment. The most likely reason for a prepayment slowdown is higher mortgage interest rates.

Certainly high on the list of mixed blessings from last year are the disturbing disruptions in liquidity for mortgage backed securities. Thus, the drop in security trading volume, regardless of the reasons, and even the corresponding decline in mortgage rates, is ill-timed. Some investment banking firms had already begun to trim their mortgage securities departments, in the aftermath of substantial losses in the spring and fall. Although major dealers remain active in the market, retrenchment in trading at a time when volume is thin poses a potential threat to liquidity, which has been the greatest benefit of securities trading to mortgage lenders and borrowers.

Clearly there is some rethinking of the role of mortgage backed securities, until recently a principal source of profits for several investment banking houses, and the resources that might in future be devoted to improving the marketability of mortgage products.

This is unwelcome news for borrowers. There are fewer portfolio investors available to buy ARMs than the investment base the capital markets provide. If and when they have their fill of ARM product, there may be little incentive to price loans attractively. A market moving towards a less liquid instrument, in conjunction with reduced efforts to address liquidity problems, could present problems in the long run for homebuyers seeking financing at reasonable costs.

UPDATE ON THE FY 1988 BUDGET PROCESS

by
Frederick E. Flick
Division Vice President
Forecasting and Policy Analysis

Introduction

In last month's issue of the Real Estate Outlook (Taxing and Spending Washington Style: A Closing view of the FY 1988 Budget Process) we tracked the process to the point where a joint House-Senate Conference Committee was meeting in the middle of December to put together a final package of taxing and spending increases that both Houses could agree upon and that the President could support.

The joint package which Congress was considering involved two bills: an omnibus reconciliation measure which wrapped annual appropriation bills for 13 separate government departments (none of which had been separately passed this year) into a single measure; and a deficit-reduction package of tax increases, sales of federal assets, and cuts in some parts of otherwise non-appropriated programs such as Medicaid, Medicare, and farm subsidies.

The budget bill totalled $598 billion for programs/operations dependent on annual spending bills; however, it is important to note that total Federal expenditures for FY 1988 should be about $1 trillion as they will include entitlement programs such as Social Security, Medicare, and Medicaid. Since October 1 (the beginning of FY 1988), the government had been operating under four short-term continuing resolutions, providing "on-going" funding at last year's levels.

The President signed the two bills on Dec. 22. The deficit reduction bill is expected to reduce the federal deficit by $17.6 billion in 1988. The two measures are projected to reduce the budget deficit by $33.2 billion in FY 1988 and $79 billion over the next two years. These figures exceed the targets of the November 20 deficit reduction agreement. The President was critical of the process, especially the wrapping of the 13 unpassed appropriation bills into the single omnibus spending measure. Furthermore, because the government had been running on several consecutive continuing resolutions at FY 1987 spending levels if the President had not signed the bills, the government would have shut-down, at least until another short term extension at 1987 levels was passed. Nevertheless, everyone was happy the budget had finally been passed and the President offered his congratulations by telephone to the leaders of Congress.

Policy Issues Involved in the Budget

The budget process of the last two years has involved an end of the year "wrapping-up" of individual appropriations bills into a single omnibus bill (without prior completion and Presidential signature of individual agency/department budget bills). Furthermore, because the budgets of individual government agencies embody much of the program impact and policy direction of individual agencies/departments, the debate is not simply over spending and taxing numbers, but also over policy issues.

One concern was the Administration's objection to reinstatement of the Fairness Doctrine in one of the bills. Also, the Administration had wanted larger cuts in Medicare, Postal Service spending, and larger proposed asset sales. However, for accepting promises to make further deficit reductions in these areas next year, it secured exclusion of the Fairness Doctrine from the package. However, the most important policy debate centered on providing further non-lethal aid to the Nicaraguan contras. Under a compromise that was worked out, the contras would receive $8.1 million through the end of February and Congress would vote again on additional aid in early February.

Provisions of the Spending Bill

The $598 billion appropriations measure includes the following major provisions:

- Non-lethal funding of $8.1 million for the Nicaraguan contra rebels through the end of February, allowing shipment of previously authorized military aid until Jan. 12. It also guarantees House and Senate votes on Feb. 3 and 4 on any new Reagan administration request for further military aid.
- Spending cuts in government programs of $15.6 billion, including $5 billion in military and $2.6 billion in domestic discretionary programs covering such items as education and law enforcement. The bill includes $3.9 billion for the Strategic Defense Initiative; the President requested $5.7 billion.
- The administration can sell up to 70 Stinger antiaircraft missiles to Bahrain, but that nation would have to return any unused missiles within 18 months.
- The administration can resume sending $480 million in foreign aid to Pakistan if it waives current law barring aid to nations that have a nuclear weapons capability but do not submit to international inspection.
- Most federal workers receive a 2 percent pay increase, except members of Congress, federal judges and senior executives.
- Delays by eight months the imposition of financial penalties against metropolitan areas that fail to meet pollution standards for ozone and carbon monoxide under the Clean Air Act.
- Provides $905 million for AIDS research, nearly double last year's amount.

- Allows 20 states to increase the speed limit to 65 mph on rural four-lane highways for four years. Currently states can raise the limit only on rural interstate highways.

The second bill passed by Congress and signed by the President involved two components: 1) tax increases to raise revenue through increases on corporations and well-off individuals; 2) and, a package of asset sales and cuts in non-appropriated programs to reduce the deficit by $17.6 billion. The tax component includes the following provisions:

- Extend the 3 percent tax on telephone service, which otherwise would have expired at the end of this year.
- Limit the deduction for interest on a home mortgage to loans of $1 million or less, for up to two residences.
- Limit the deduction for other loans (i.e., home equity/second mortgages) using a home as security to amounts of $100,000.
- Individuals who pay taxes on an estimated basis can pay only 80 percent of their ultimate bill in advance rather than 90 percent as current law requires.
- Freeze the top rate on estate and gift taxes at the current 55 percent for five years, rather than allowing it to fall to 50 percent next year.
- Require inactive-duty military reservists, some agricultural workers and children who work for their parents to pay Social Security taxes.
- Deny the tax credit for child care for the expenses of sending a child to overnight camp.
- Extend a 0.2 percent surtax on the unemployment-insurance tax paid by employers for three years.
- Close an estate-tax loophole opened by the 1986 tax law that provided advantages for investing in employee stock ownership plans (ESOP).
- Accelerate the collection of estimated taxes paid by corporations.
- Increase the base contributions companies make to the Pension Benefit Guaranty Corp. from $8.50 per employee to $16, with additional contributions of up to $34 possible for companies with underfunded pension plans.
- Raise the railroad-retirement tax and permit the general fund to subsidize the railroad fund for one year.
- Impose a 50 percent tax on stock gains by corporate "raiders" incurred when they try to take over a company.
- Require defense and construction contractors to pay taxes on at least 70 percent of their income each year rather than the current 40 percent.
- Deny use of the foreign tax credit to income American companies earn on operations in South Africa.

The second component of the reconciliation bill provided the following cuts:

- Cut the growth of Medicare by $2.1 billion in 1988 and $3.6 billion in 1989. About $550 million of the 1988 savings would come from extending the automatic spending cuts through next April for most Medicare programs. However, spending for Medicaid will be increased by $44 million in 1988 and $633 million over three years.
- Allows retiring federal workers in fiscal 1988 and 1989 to take only 60 percent of their benefits in the year they retire, rather than the entire lump sum that they are now allowed. They could take the remaining 40 percent the following year.
- Postpone some future U.S. Postal Service construction and require the USPS to compensate the general fund for some health-benefit costs for retirees. The Postal Service would not be allowed to raise rates to cover the higher costs.
- The Energy Department will select Yucca Mountain, Nevada as the site of the nation's first and only high-level nuclear waste dump.
- Reduce agricultural target prices and loan rates for major commodities.

Sources: The Washington Post, "Spending, Tax Bills Signed by President," by L. Cannon and A. Sewardson, p. A-1, A-6; and "Provisions of the Bills," p. A-6, December 23, 1987.

Principal Provisions of The New Tax Law

The tax provisions are expected to raise $9 billion of additional revenue in fiscal 1988 and $14 billion in 1987. Increases in corporate estimated tax payments are expected to raise $1.7 billion, but only $850 million was considered in meeting the 1988 target. A number of proposals considered in the House and Senate were dropped by the conferees:

- Technical corrections to the Tax Reform Act of 1986.
- The increase in the corporate minimum tax preference item from 50 percent to 100 percent of book-tax difference.
- Non-deductibility of interest on borrowing for corporateacquisitions.
- Limiting tax deferral for like-kind exchanges of real property.
- A de minimis exception to the look-back method under the long-term contract rules.
- Amortization of customer base intangibles.
- A parent's election to claim unearned income of dependent on return of parent.
- Elimination of the dividends-received deduction on stock that has non-stock characteristics.
- Limitation on consolidated return passthrough.
- Mandatory Section 338 election for hostile tender offers.
- Changes in tax treatment of mergers and acquisitions of bankrupt corporations.
- Repeal of exceptions to below-market loan rules for continuing care facilities.
- Current taxation of market discount on bonds.
- Repeal of state death tax credit under the estate and gift tax.

- Minority discounts under the special valuation rules.
- Limitation of the taxable benefit option under cafeteria plans.
- Non-deductibility of interest on debt used to purchase or carry tax-exempt installment obligations.
- Collection of tax from partnerships.
- The "runaway plant" proposal whereby certain imported property income of a CFC would be denied deferral and subject to a separate foreign tax credit limitation.
- The change in tax treatment of certain insurance syndicates.
- The change in tax treatment of net investment income of trade associations.
- Modifications to low-income housing credit.
- Repeal of the ceiling on income subject to the Medicare tax.
- Modification of the COBRA health care continuation coverage penalty.

The provision that would have had the heaviest impact on the real estate industry is the loss of tax liability deferral on like-kind exchange capital gains. Because this item was salvaged, 1988 could become a big year for this type of transaction. However, the $1 million cap on principal for interest deductibility and part of the restrictions on home equity loan interest ($100,000 married and $60,000 for singles) were passed. The provision that would have excluded boats and mobile homes as second residences was dropped.

Source: Coopers and Lybrand, "An Overview of the Principal Provisions of the 1987 Tax Act," Tax Notes January 4, 1988, pp. 67-75.

Epilogue

The March issue of the Outlook will provide a more detailed presentation of the major real estate-related provisions of the new tax law and, if space permits, an overview of the President's proposed budget for FY 1989 (beginning October 1, 1988) which will be sent to Congress and released to the public on or about February 15.

Of course, preliminary versions of this document, currently being finalized, have already been leaked to the press causing some concerns over proposed "cuts" and "shifts." Thus, although we are just a little over a month past the enactment of the FY 1988 budget, the debate on the dollars and issues of the FY 1989 budget has already began. In Washington, budgeting and the accompanying political machinations are an on-going feature of work and life in the shining city on the hill.

SPECIAL TOPIC:
FOREIGN INVESTMENT IN U.S. REAL ESTATE

The NATIONAL ASSOCIATION OF REALTORS® Forecasting & Policy Analysis Division and the International Affairs Division recently released a joint project entitled "Foreign Investment in U.S. Real Estate: The New International Landlords." The purpose of the report was to promote a better understanding of the role foreign investment plays in the United States economy, in light of the increasingly integrated world economy in which we operate. Its particular importance to U.S. real estate is examined through a study of foreign investment behavior in three U.S. cities: Los Angeles, Washington, D.C., and Chicago.

The integration of the world's economies and financial markets, spurred on by technological advances in information processing has greatly heightened awareness of worldwide investment alternatives. Huge international flows of capital have signaled the approval of foreign investors to this expanded universe of investment options. Given the freedom to choose, foreign investors have invested huge sums in the U.S. economy, through either portfolio investments or direct investments in U.S. industries, including real estate.

The financial strength to capitalize on these worldwide opportunities has in the past lain with American and European institutional investors. Today, large trade surpluses between Japan and its trading partners coupled with a stronger yen in dollar terms has refocused investor activity from Western Europe to Japan.

Reasons given by these foreign investors include the higher rate of return available in the U.S.; a large and diverse market offering investments ranging from U.S. Treasury bonds to regional shopping malls; a deep market that promises an abundance of buyers for almost any investment held for future disposition; a stable government; a highly skilled labor force; a less onerous tax system: in sum, the largest and most unfettered economy the world has yet known. A few statistics illustrate how these foreign investors are expected to choose.

Foreign investors will send an estimated $150 billion into the U.S. economy in 1988, of which 75 percent (or about $110 billion) will be directed into portfolio investments, like U.S. Treasury securities or corporate bonds. Currently, Japanese investors account for the largest share of this investment, contributing 25 cents of every dollar of foreign portfolio investment in the U.S. The remaining 25 percent ($40 billion) will be invested directly into U.S. industries, including purchases of U.S. real estate, which could total $10 billion in 1988.

Progress in the sale of U.S. housing-related assets to foreign investors is an important part of this portfolio investment inflow because proceeds can be used by U.S. thrifts to expand housing activity in their region. U.S. thrifts have raised nearly $10 billion in overseas capital markets, and foreign investors have become increasingly receptive to their offerings as they have gained a better understanding of these securities. During 1987, these and other portfolio investments expanded the pool of investment funds available to the U.S. housing industry, contributing to an additional 800,000 sales of 1-4 family homes. The value of these additional home sales due to foreign financing is estimated to be $68 billion.

The value of foreign direct investments in U.S. industry rose by $24.7 billion to a total year-end position of $209 billion. Government experts estimate that this figure translates into a total asset value of more than $1 trillion.

A study commissioned by the NAR International Affairs Division and executed by the Massachusetts Institute of Technology/Center for Real Estate Development analyzed foreign investment in U.S. real estate in Los Angeles, Washington, D.C., and Chicago. This research sought to determine whether there were characteristic differences between foreign investors and their American counterparts. Differences in investor preferences were found and documented. Also, the amount of foreign investor involvement in each of the three cities was found to vary substantially and for different reasons. Here are the findings of the study.

The data derived from each of the three city analyses confirms the bi-coastal nature of foreign investment, and that foreign investors have clear preferences between these coastal cities. More than half (51.6 percent) of the 12.1 million square feet of office space in the Los Angeles central business district (CBD) is foreign-owned. Foreign ownership of the Washington, D.C. CBD is 25 percent of 53 million square feet. Information on foreign- owned office property in Chicago was difficult to develop, but approximately 7 percent of the total suburban and CBD market, and as high as 10 percent of the CBD is believed to be foreign-owned.

Investor profiles for each of the three cities revealed a mix of European, Middle Eastern, Canadian, and Japanese investors. The extent of the mix varied among cities. The Washington, D.C. CBD had the heaviest concentration of European investors, Los Angeles the most Japanese. In all three cities, Japanese investors are currently the most active.

The study concluded that foreign investors have an overwhelming preference for purchasing high-quality office buildings in downtown locations. This is partly explained by the preponderance of Japanese investments picked up by the study. It is also explained by a strong cultural history for investing in downtown areas that is characteristic of foreign investors and a feeling of confidence in going with a

familiar starting point (suburban office buildings are mostly American phenomena). Furthermore, because purchase decisions are subject to head office approval, a high-quality office property is the most likely to generate a positive response.

The longer a foreign investor operates in U.S. real estate markets, the more the investor is likely to adopt the same practices of American counterparts, including purchasing different property types in less central locations. This point is especially borne out by the data showing European investors in Washington, D.C. and Japanese investors in Los Angeles who have made substantial real estate investments outside the CBD, sometimes in non-office properties.

The oft-heard statement that foreign investors are paying too much for U.S. real estate is not entirely true. Japanese investors' strong preference for downtown office properties has driven them to pay more for these types of properties than American and other foreign investors are currently willing to pay. Part of this premium is due to a lack of familiarity with other types of office building investments and is expected to disappear eventually.

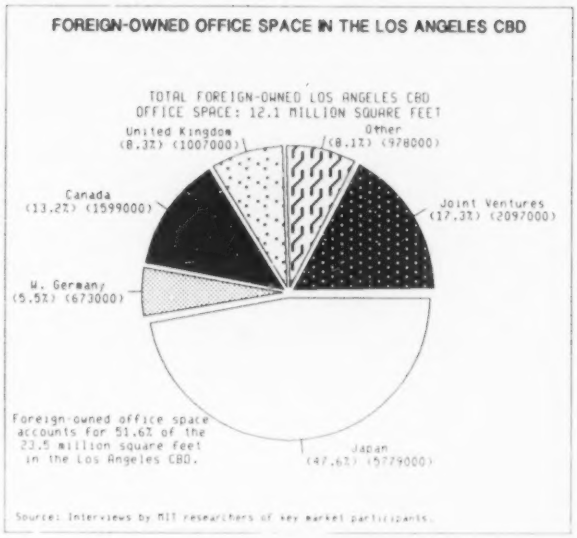
Foreign investors desire a longer holding period than do their American counterparts, because they perceive U.S. real estate as a safe haven for capital that offers attractive long term yields. This finding confirms that the current wave of foreign investment is not motivated by a desire to turn a quick profit.

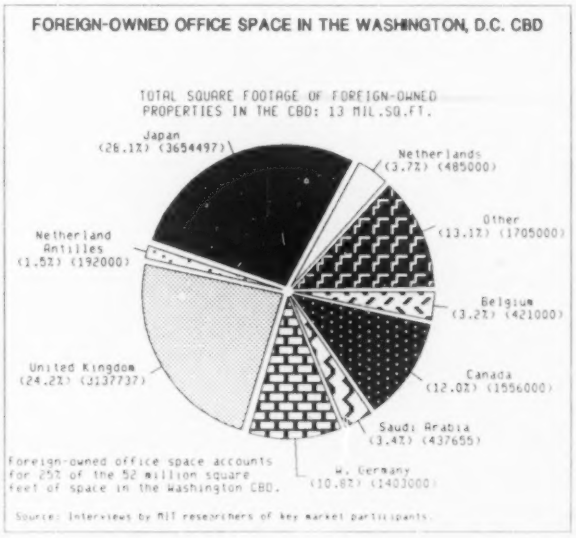
Foreign investors interviewed in all three cities were found to be relationship oriented in their approach to real estate transactions. This has two implications: Japanese investors view real estate as a long term investment so the need to quickly close an individual transaction is rarely felt; and Japanese investors prefer to establish a relationship with one firm for most of its real estate information needs. This has precedent that extends back hundreds of years within the Japanese business community. Caution will be overcome as the Japanese become more accustomed to the U.S. market.

Foreign investment transactions are indeed different from those deals involving American real estate concerns. Simple deal structures on purchases of U.S. real estate by foreign investors are the norm. Usually, the deal is a 50 to 100 percent cash transaction. Foreign investors are not comfortable with a minority ownership role.

Foreign investors are expanding their involvement in the U.S. real estate industry to include directly financing U.S. investments by U.S. investors (sometimes in exchange for an interest in the property), providing letters of credit to U.S. companies, operating leasing and building management firms, and opening Japanese real estate brokerage firms.

Copies of the study may be ordered by calling: NATIONAL ASSOCIATION OF REALTORS®
Catalog Sales (312) 329-8218
This study is item number 186-08.
The cost of the study is $15 for Members, $20 for Nonmembers.


FOREIGN-OWNED OFFICE SPACE IN THE LOS ANGELES CBD
TOTAL FOREIGN-OWNED LOS ANGELES CBD OFFICE SPACE: 12.1 MILLION SQUARE FEET
United Kingdom (8.3%) (1007000)
Other (8.1%) (978000)
Canada (13.2%) (1599000)
Joint Ventures (17.3%) (2097000)
W. Germany (5.5%) (673000)
Foreign-owned office space accounts for 51.6% of the 23.5 million square feet in the Los Angeles CBD.
Japan (47.6%) (5779000)
Source: Interviews by MIT researchers of key market participants.


FOREIGN-OWNED OFFICE SPACE IN THE WASHINGTON, D.C. CBD
TOTAL SQUARE FOOTAGE OF FOREIGN-OWNED PROPERTIES IN THE CBD: 13 MIL.SQ.FT.
Japan (28.1%) (3654497)
Netherlands (3.7%) (485000)
Other (13.1%) (1705000)
Netherland Antilles (1.5%) (192000)
Belgium (3.2%) (421000)
United Kingdom (24.2%) (3137737)
Canada (12.0%) (1556000)
Saudi Arabia (3.4%) (437655)
W. Germany (10.8%) (1403000)
Foreign-owned office space accounts for 25% of the 52 million square feet of space in the Washington CBD.
Source: Interviews by MIT researchers of key market participants.

NUMBER OF FOREIGN-OWNED PROPERTIES IN CHICAGO BY NATIONALITY OF INVESTOR
NUMBER OF FOREIGN-OWNED PROPERTIES IN CHICAGO: 26
SAUDI ARABIA (11.5%) (3)
UNITED KINGDOM (11.5%) (3)
SWITZERLAND (7.7%) (2)
W. GERMANY (7.7%) (2)
NETHERLANDS (19.2%) (5)
JAPAN (42.3%) (11)
Square foot estimates by nationality of investor could not be computed. Overall, foreign investors own 7 percent of Chicago office space.
Note: Data includes 7 pending transactions involving Japanese investors. Canadian-owned properties are not included.
Source: Interviews by MIT researchers of key market participants.